Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Separation of costs of regulated telephone service from costs of nonregulated activities.	)	
	)	CC Docket No. 86-111
Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to provide for nonregulated activities and to provide for transactions between telephone companies and their affiliates.	)	

ORDER ON RECONSIDERATION

Adopted: September 17, 1987 **Released: October 16, 1987**

By the Commission:

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1. INTRODUCTION

1. On February 6, 1987, we released a Report and Order in this docket setting forth mechanisms by which AT&T and the local exchange carriers were required to separate the costs of providing regulated telecommunications services from the costs of providing nonregulated products and services. [1]Our chief concern in adopting cost allocation mechanisms was to promote just and reasonable rates for regulated interstate services. [2]We established two separate but complementary sets of rules, one setting forth a cost allocation process to separate the cost of regulated and nonregulated activities offered by a carrier, [3]and the other governing transactions for goods and services between a carrier and its affiliates. [4]We found that these rules were necessary to discourage carriers from subsidizing the costs of nonregulated services by shifting nonregulated costs to regulated activities, and to assure that ratepayers share in any efficiencies generated from joint use of the network by nonregulated activities. We also resolved a host of issues concerning the application of our rules to various classes of carriers and to specific activities as well as a number of issues concerning accounting, implementation, and enforcement.

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[1] Separation of costs of regulated telephone service from costs of nonregulated activities, *Report and Order*, CC Docket No. 86-111, 2 FCC Rcd 1298 (1987) (hereinafter Joint *Cost Order* or *Order).* Petitions for Reconsideration were due April 6, 1987. Oppositions were due May 15, and Replies were due May 28. Motions for acceptance of late-filed pleadings were filed by CompuServe Incorporated and Capital Cities/ABC, Inc., CBS Inc., and National Broadcasting Company The motions, which are unopposed, are hereby granted.

[2]*Joint Cost Order*, 2 FCC Rcd at 1303.

[3] Section 64.901 of the Commission's Rules, *printed in 2* FCC Rcd at 1343.

[4]Sections 31.01-11 and 32.27 of the Commission's Rules, *printed in* 2 FCC Rcd at 1342, 1345.

2. In this Order on Reconsideration, we largely affirm the determinations which we reached in the *Order,* although we modify and clarify several aspects of our decision. In recognition of the practical limits on the ability of carriers to forecast far into the future the relative usage of their networks by regulated and nonregulated activities, we are shortening the forecast period to be used for developing forward-looking allocators for network plant from average depreciable life to three years. Forecast periods shorter than three years can be employed, provided that a carrier makes the following showing: (a) proof that the relevant engineering period is less than three years; (b) a demonstration that the planning and deployment process is not merely the activation of capacity that is already in place but not yet in service; (c) a particularized demonstration that use of the shorter forecast period will result in substantially more accurate cost allocations; and (d) a demonstration that the overall costs of implementing shorter periods do not exceed the benefits. In response to criticisms of the general allocator, we have decided that carriers should employ quarterly data from the three-month period ending two months before the current month. By imposing a two-month gap between the close of a rolling quarter and the current month, there will be ample time for carriers to record expense data and develop the allocator before applying it to current accounts. We also agree that records relating to employee time should be retained for one year beyond the close of the fiscal year to which the records relate to ensure that essential records will be available for auditing. We have also clarified our asset transfer rules to explain that the value of an asset sold in the normal course of an entity's business can be established by reference to the entity's prevailing price for the asset, in addition to the price as it appears in a tariff. The prevailing price need not be memorialized in a price list. We also clarify that we intended to exempt average schedule companies from the cost allocation and affiliate transaction rules. In all other respects, our *Order* is affirmed.

3. This Order is divided into six substantive parts. Section II explains the background of this proceeding. Section III resolves the cost allocation issues raised on reconsideration, while Section IV concerns the affiliate transactions rules. Section V discusses the general issues of the scope and applicability of the *Joint Cost Order,* including the *Order's* applicability to small carriers and connecting carriers. Section VI addresses issues concerning implementation and enforcement of our rules. Finally, Section VII contains a discussion clarifying several accounting issues that have been raised since the *Joint Cost Order* was released.

II. BACKGROUND

4. The origins of the *Joint Cost* proceeding can be found in the *Computer II* proceeding, [5] which preemptively removed enhanced services and customer premises equip-

[5] Second Computer Inquiry, *Final Decision,* 77 FCC 2d 384, *modified on reconsideration,* 84 FCC 2d 50 (1980), *further modified on reconsideration,* 88 FCC 2d 512 (1981), *aff 'd sub nom. Computer and*

(continued...)

ment (CPE) from regulation as common carrier communications services[6] and required AT&T and its operating companies to offer these nonregulated products and services through structurally separated affiliates. Our *Computer II* decision also required all carriers to unbundle their basic and enhanced offerings, and to obtain basic services under the same terms and conditions as provided in their tariffs when providing enhanced services.[7]

5. Under *Computer II*, AT&T and its operating companies were generally precluded from joint operation or joint marketing with their nonregulated affiliates. The nonregulated affiliates, however, were permitted to obtain certain services from the regulated entity, subject to the submission of acceptable accounting and cost allocation plans. In addition, affiliate transactions were required to be reduced to writing and filed with this Commission. A modified version of the *Computer II* rules was applied to the Bell Operating Companies (BOCs) upon their divestiture from AT&T on January 1, 1984.[8]

6. We did not require structural separation for the provision of nonregulated activities by the independent local exchange carriers. These carriers were permitted to integrate their regulated and nonregulated offerings, subject to the unbundling requirement, provided that they accounted separately for nonregulated activities. We established two accounts, one for nonregulated investment, and one for nonregulated income, in order to track nonregulated

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[5](...continued)
Communications Industry Ass' n v FCC, 693 F. 2d 198 (D.C. Cir. 1982), *cert denied* 461 U.S. 938 (1983), *aff' d on second further reconsideration,* FCC 84-190 (released May 4, 1984) (hereinafter *Computer II)*

[6] Carriers were permitted to offer basic, traditional communications services on an unseparated basis Enhanced services had to be provided through a separate subsidiary, and were defined as follows.
The term "enhanced service" shall refer to services offered over common carrier transmission facilities used in interstate communications, which employ computer processing applications that act on the format, content, code, protocol or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different or restructured information; or involve subscriber interaction with stored information.

47 C.F.R. 564.702(a).

[7] 47 C.F.R. § 64.702.

[8] Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Equipment by the Bell Operating Companies, *Report and Order,* 94 FCC 2d 1117 (1984), *aff, d sub nom. Illinois Bell Telephone Co. v FCC,* 740 F. 2d 465 (7th Cir. 1984), *a' d on reconsideration* FCC No. 84-252, 49 Fed. Reg. 26056 (1984), *aff'd sub nom. North American Telecommunications Association v.* FCC, 772 F. 2d 1282 (7th Cir. 1985).

activities that are not conducted through a subsidiary.[9] Investment shared by regulated and nonregulated activities continued to be recorded in the regulated account, although we required the independent carriers to employ a fully distributed costing system to allocate common costs between regulated and nonregulated activities. We indicated at the time we adopted these accounting rules that we would establish in a future proceeding cost allocation rules to govern the distribution of shared expense and common investment.

7. In 1985, we opened the *Computer III* proceeding[10] to reexamine our treatment of enhanced services under *Computer II.* In reviewing the costs and benefits of structural separation of enhanced services by AT&T and the BOCs, we decided that structural separation had produced substantial costs in terms of decreased efficiency and innovation. We therefore replaced structural separation with a system of nonstructural safeguards, including Open Network Architecture (ONA) and Comparably Efficient Interconnection (CEI). CEI and ONA were intended to prevent discrimination in access to basic services for competitive providers of enhanced services and to promote the efficient use of the telecommunications network. A BOC may not abandon structural separation for enhanced services until it has obtained our approval of an ONA plan describing how access to its network will be provided to its enhanced services competitors. The BOCs ONA plans are due no later than February 1, 1988. AT&T must file a CEI plan for each enhanced service which it offers on an integrated basis. Neither AT&T nor the BOCs may actually offer enhanced services without structural separation until they have obtained approval of a joint cost allocation manual, as mandated by the instant proceeding.

8. Concurrently with our consideration of our treatment' of enhanced services in the *Computer III* proceeding, we were also reevaluating our requirement that AT&T and the BOCs structurally separate their provision of CPE. First for AT&T in 1985,[11] and then for the BOCs in 1987,[12] we decided to replace structural separation with a system of nonstructural safeguards. We permitted AT&T to implement structural relief immediately under an interim

[9] Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), *Fifth Report and Order,* FCC 84-547, 49 Fed. Reg. 46378 (Nov. 26, 1984).

[10] Amendment of Sections 64.702 of the Commission's Rules and Regulations *(Third Computer Inquiry), Notice of Proposed Rulemaking,* CC Docket No. 85-229, 50 Fed. Reg. 33581 (Aug. 20, 1985), *Third Computer Inquiry (Phase I Order), Report and Order,* 104 FCC 2d 958 (1986), *modified on reconsideration,* 2 FCC Rcd 3035 (1987), *Third Computer Inquiry (Phase II Order),* 2 FCC Rcd 3072 (1987).

[11] Furnishing of Customer Premises Equipment and Enhanced Services by American Telephone and Telegraph Company, 102 FCC 2d 655 (1985) *modified in part on reconsideration* 104 FCC 2d 739 (1986).

[12] Furnishing of Customer Premises Equipment by the Bell Operating Companies and the Independent Telephone Companies, 2 FCC Rcd 143 (1987).

accounting and cost allocation plan,[13] which was to remain in effect until a permanent cost allocation mechanism was adopted and implemented pursuant to this *Joint Cost* proceeding BOCs may not implement full structural relief for their CPE activities until we have approved their permanent cost allocation manuals.[14]

9. On April 17, 1986, we released a Notice of Proposed Rule Making (NPRM) in this docket.[15] The NPRM examined various cost allocation mechanisms and accounting plans then in use by carriers, as well as recommendations from the General Accounting Office and the Telecommunications Industry Advisory Group. We proposed two alternative approaches to cost allocations--one modeled on the jurisdictional separations process and the other based on a service costing approach. Both approaches required the submission of cost manuals by carriers, and provided for continuing oversight and enforcement by this Commission. The NPRM also proposed affiliate transaction rules and accounting procedures for nonregulated activities.

10. The resulting *Joint Cost Order* adopted a set of general cost allocation principles which include elements of both cost allocation proposals. The methodology adopted seeks to maximize the ability of carriers to associate costs with their causes by establishing a hierarchy of assignment, attribution, and allocation principles which form the basis of the cost allocation process.[16] Pursuant to these principles, carriers allocate costs by formulating homogenous "cost categories" from among the accounts prescribed in the Uniform System of Accounts (USOA).[17] Attribution or allocation mechanisms for individual cost categories are required to be listed in a cost allocation manual.[18]

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[13] *See* Furnishing of Customer Premises Equipment and Entranced Services by American Telephone & Telegraph Company, Mimeo No. 5652, released July 11, 1986.

[14] See supra note 12 at 163.

[15] Separation of costs of regulated telephone service from nonregulated activities, *Notice of Proposed Rulemaking*, 104 FCC 2d 59 (1986).

[16] The principles have been codified at Section 64.901 of the Commission's Rules. *See Joint Cost Order.* 2 FCC Rcd at 1343.

[17] *Joint Cost Order*, 2 FCC Rcd at 1319. Carriers were directed to file manuals based on the revised USOA that will become effective January 1, 1988. *See Revised USOA*, 51 Fed. Reg. 43493 (December 2, 1986). We also decided that the BOCs seeking to take advantage of interim relief from structural separation could file interim cost manuals for 1987 based on the current USOA. The current USOA is codified at 47 C.F.R. §31 *et seq. (* 1986).

[18] *Joint Cost Order*, 2 FCC Rcd at 1327.

11. Although the carriers will propose many of the initial attribution or allocation mechanisms, we selected an allocator for cost categories consisting of central office equipment and outside plant. These cost categories are allocated based on "relative regulated and nonregulated usage of the investment at the highest forecast relative nonregulated usage over the life of the investment."[19] Use of a forward-looking allocator for this type of investment is intended to reflect network plant investment decisions, which are based on future anticipated network usage.

12. In conjunction with the cost allocation requirements, this Commission adopted a set of affiliate transaction rules, which are designed to discourage cost shifting between regulated and nonregulated activities. These rules establish specific valuation methodologies to determine the price at which an asset transfer is recorded. The valuation standards are intended to minimize the ability of regulated enterprises and their affiliates to manipulate asset values in such a way as to disadvantage ratepayers.[20] In addition to the asset valuation rules, the provision of services between affiliates are to be valued based on a tariff or price list, if either of these exist. If not, the costs of the service are to be apportioned in accordance with the cost allocation principles, as if the corporate boundary between the separate entities did not exist.[21]

13. The *Joint Cost Order* also resolved a number of other issues concerning cost allocations for joint regulated and nonregulated activities. The *Order* discussed the treatment of specific activities and the resolution of special cost allocation problems in the areas of employee time reporting, marketing, and allocation of depreciation reserves. The *Order* also discussed the accounting methods to be used for nonregulated activities. In addition, the *Order* required that AT&T and the larger exchange (Tier 1) carriers[22] be audited by an independent auditing firm annually to verify compliance with the cost manuals and to determine if the cost allocations performed are the product of accurate methods.[23] Only AT&T and the Tier 1 carriers are required to file their manuals with this Commission for

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Section 64.901 of the Commission's Rules, *printed in* 2 FCC Rcd at 1343.

Id. at 1335-36.

Id. at 1336.

Tier 1 carriers consist of all local exchange carriers having $100 million in total company regulated revenues, as determined by the 1984 Annual Statistical Volume II of the USTA Statistical Reports of Class A & B Telephone Companies. *Commission Requirements for Cost Support Material To Be Filed with 1988 Annual Access Tariffs,* Mimeo No. 4219, released July 30, 1987.

Joint Cost Order, 2 FCC Rcd at 1330.

approval.

14. Petitions for reconsideration were received from 21 parties objecting to various aspects of the *Order*. Parties also filed 21 oppositions to the petitions. and 19 replies.[24]

III. COST ALLOCATION STANDARDS

15. In the *Joint Cost Order* we adopted an attributable cost method of fully distributed costing, which requires that carriers directly assign costs to either regulated or nonregulated activities whenever possible. Common costs. that is, costs which cannot be directly assigned, are to be grouped into homogeneous cost categories.[25] If a cost causational allocation is possible, a cost category is to be allocated based on direct analysis of the origins of the costs or based upon a cost-causative linkage to another cost category for which a direct analysis exists. Costs that cannot be assigned or allocated based on any cost causative measure are allocated using a general allocator computed by using a ratio of all expenses directly assigned or causally attributed to regulated and nonregulated activities.[26] In order to assure proper allocation of long-term investment to new nonregulated services, we required that central office equipment and outside plant investment be allocated based on forecast, rather than current relative use.[27] In addition to establishing basic cost allocation standards, we addressed and resolved a number of specific cost allocation issues. including several matters relating to employee time reporting.[28]

16. Parties have raised issues on reconsideration concerning the cost allocation standards for central office equipment and outside plant, the composition of and application of the general allocator, and methods of recording employees' time.

A. Central Office Equipment and Outside Plant

17. The *Joint Cost Order* Provides:

A list of the parties filing petitions, oppositions and replies appears as Appendix A.

[25]Accountants also refer to cost categories created for this purpose as "cost pools."

[26] *Joint Cost Order*, FCC Rcd at 1317-19.

[27]*Id* at 1319-20.

[28]*Id* at 1320-26.

The allocation of central office equipment and outside plant investment cost between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment at the highest forecast relative nonregulated usage over the life of the investment.[29]

Carriers are therefore required to forecast both regulated and nonregulated usage or common network equipment over the entire depreciable life of the equipment. Using those forecasts, carriers determine the point during the life of the equipment at which nonregulated use will constitute the greatest percentage of total use. The ratio of nonregulated use to total use at that point is then used to allocate a portion of the equipment to nonregulated activities, beginning at the time of purchase (for new investment), or at the time when first put to common use (for embedded investment). A carrier may use a forecast period shorter than the depreciable life of the investment if it makes a specific showing as to the planning period for that category of investment.[30] Furthermore, nonregulated investment within a cost category may not decrease from one year to the next, absent waiver.[31] If a carrier underforecasts nonregulated use reallocation of investment from regulated to nonregulated activities must be made at undepreciated baseline cost[32] and must include interest calculated at the authorized interstate rate of return.[33]

18. In their petitions for reconsideration, carriers challenge the length of the forecast period, the determination of allocation factors based on peak relative nonregulated usage, and the restrictions on reallocation of investment. We address each of these issues separately below.

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[29] Section 64,901(b)(4) of the Commission's Rules, *printed in* 2 FCC Rcd at 1343. As part of this Order on Reconsideration, we are making a minor amendment to Section 64.901(b)(4) to replace the phrase " . , at the highest forecast relative nonregulated usage . , " with " . . during the year when nonregulated usage is greatest in comparison to regulated usage . . . " See Appendix B. We believe the amended language more clearly communicates the intent of the rule without altering its meaning. Because the meaning of the rule has not been changed, and the amendment is purely editorial in nature, we find that good cause exists to make the amendment without notice and comment Rule Making U.S.C. § 553(b)(3)(B).

[30] 2 FCC Rcd at 1319-20

[31] The *Order* established the following waiver criteria for reallocating investment from nonregulated activities to regulated operations: regulated operations must (1) need additional capacity and (2) be unable to obtain that additional capacity at a lower cost from any other source. 2 FCC Rcd 1320 and n. 284.

[32] Baseline cost is defined as either the depreciated original cost at the time the equipment was initially placed in joint use or the original cost of new plant. *Joint Cost Order.* 2 FCC Rcd at 1320.

[33] *Id*.

1. Forecast Period

a. Positions of the parties

19. All carriers subject to the requirements of the *Joint Cost Order* who have petitioned for reconsideration seek modification or rejection of the requirement that forwardlooking investment allocators be developed based on forecast usage over the depreciable life of an investment. Most argue that they cannot forecast relative nonregulated and regulated usage over the lengthy depreciation lives of most network plant.[34] According to the carriers, reasonably accurate forecasts of usage cannot be made beyond a planning horizon of a few years. Unforeseen and unpredictable events, such as changes in the economy, advances in technology, and the development of competing services, render attempts at long-term forecasts futile. They argue that shorter forecast periods of several years are therefore a far more realistic regulatory requirement for carriers to meet.[35]

20. In addition to the arguments concerning the inaccuracy of depreciable life forecasts, several carriers argue that a shorter forecast period is more in keeping with the increasingly modular nature of network plant investment. BellSouth states that on an annual basis, it adds capacity to about 50 percent of its central offices, based on semiannual forecasts. USTA argues that investment decisions concerning central office equipment are made every one to three years, while decisions about outside plant are made every three to five years.[36] According to these parties, the increasing modularity of network plant permits investment decisions to be based on much shorter intervals than depreciable life. BellSouth argues that the true "cost causers" are those who will use the network plant during the upcoming planning period, not those who will use the network in five, ten, or fifteen years.[37]

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[34]Depreciation lives vary considerably by type of plant. For central office equipment, lives of 10 to 20 years are typical. For outside plant, lives of 20 to 50 years are typical.

[35]AT&T Petition at 16-18; Bell Atlantic Petition at 9-12; BellSouth Petition at 4-10; BellSouth Opposition at 2-4; BellSouth Reply at 3-4; Contel Petition at 6; NYNEX Reply at 3-5; Pacific Companies Opposition at 2-3; SNET Petition at 11 - 14; SNET Reply at 4-5; USTA Petition at 10-13; US Sprint Opposition at 6, n. 2; U S West Petition at 19-23, and U S West Reply at 3-5.

[36]BellSouth Petition at 4-7; USTA *ex parte* presentation to the Common Carrier Bureau, June 17, 1987, Public Notice, Mimeo 4600, August 26. 1987. *See also* Contel Petition at 4-5 (network plant is capable of "easy expansion" over its service life); Southwestern Petition at 3-6 (explaining that components of central office equipment are planned and deployed over short intervals); and AT&T Petition at 15- 16.

[37]BellSouth Petition at 4-7.

21. SNET contends that we can be assured of greater reliability of the forecasts by basing a forecast on a planning cycle that is necessary for normal business planning purposes SNET, BellSouth and U S West argue that with shorter periods, carriers can avoid the "penalty" provisions associated with reallocating costs to nonregulated activities.[38] BellSouth and USTA state that shorter planning periods are similar to the planning cycles of nonregulated competitors. In addition, BellSouth and USTA argue that the *Joint Cost Order* provision allowing carriers to demonstrate a shorter planning period should not be used to justify the continuation of the depreciable life standard, since the exceptions would eventually swallow the rule.[39]

22. Contel states that revision of the existing rules is necessary if nonregulated services are to develop in rural areas, because the lengthy forecast period results in an overallocation to nonregulated activities that will forestall attempts to create nonregulated activities that share network plant.[40]

23. Most of the exchange carriers favoring shortened forecast periods claim that forecast periods should be one to five years in duration, coincident with the network planning period or engineering period for any given category of equipment.[41] Generally, carriers state that typical engineering or planning periods are about three years in length, with some variations depending upon the type of equipment.[42] Two carriers argue that the forecast period should be linked to a carrier's budget process or some other measure of commitment to construct new plant NYNEX believes the forecast period should be consistent with actual investment

[38]SNET Petition at 12-14; SNET Reply at 4-5; BellSouth Petition at 7-10; and U S West Reply at 4, n, 3. *See also U S* West Petition at 19-23 and BellSouth Petition at 7- 10.

[39]BellSouth Petition at 7- 10 and USTA Petition at 11- 13.

[40]Contel Petition at 7-9 and Reply at 3-8.

[41]Ameritech Petition at 12 (engineering life); Bell Atlantic Petition at 10- 12 (actual forecast period); BellSouth Petition at 7-8 (normal planning period); SNET Petition at 11-14 (normal advance planning period) and USTA Petition at 11-13 (normal advance planning period). Southwestern also advocated using a "standard network deployment interval" as a forecast period before adopting a different proposal based on experienced use. Southwestern Petition at 3-6 and Southwestern Opposition at 2-5.

[42]Bell Atlantic Petition at 9, n. 20 (one year for some trunk circuit equipment); BellSouth Petition at 5 (two years for modular-type equipment); Contel Petition at 6 (two to five year Southwestern Petition at 5 (one to three years). USTA Petition 12, n. 17 (one to three years for some central office equipment) and U S West Petition at 22-23 (two years).

decisions, such as a "marketing period."[43] The Pacific Companies argue for a forecast period based on a carrier's "budget commitments."[44]

24. Some parties advocate abandonment of the forecast period altogether in favor of an allocation based on actual use or "experienced use." AT&T argues that an experienced use allocation of network plant would provide the most accurate cost allocator because it would be based on objective. verifiable studies of actual regulated and nonregulated use. AT&T argues that this method is more equitable because nonregulated activities are assigned the costs of network investment that they actually use, as opposed to the current method, which immediately assigns all the costs required to meet peak demand even if demand will not peak for years. AT&T envisions actual use studies occurring "at least" annually. Fears that an allocator based on actual use would provide an opportunity to overallocate costs to the regulated activity are misplaced, according to AT&T. So long as nonregulated costs cannot be reallocated to the regulated activity without Commission approval, AT&T argues, ratepayers are sufficiently protected from cost shifting. Similarly, AT&T states that the interest payment requirements ensure that ratepayers are fully compensated for cost reallocation from regulated to nonregulated activities. AT&T also argues that experienced use is a methodology widely used in the industry and easily applied. AT&T acknowledges, however, that forecasting would be necessary, at least initially in the case of new nonregulated services.[45] GTE and Southwestern also favor an actual use methodology because it would avoid complex implementation problems, such as forecasting and tracking, that use of a forward looking allocator presents.[46] Bell Atlantic, BellSouth, Cincinnati Bell, Contel, and USTA all state that they find an "experienced use" approach acceptable.[47]

25. Several other parties agree with the carriers that the long-term forecasts required by the use of depreciation life as a planning period are impossible to execute. The D.C. Commission notes that lengthy forecast periods can be burdensome, and may discourage

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[43]NYNEX Reply at 3-5.

[44]Pacific Companies Opposition at 2-3.

[45] AT&T Petition at 19-20; AT&T Opposition at 5-8; and AT&T Reply at 7, n. ****.

[46]GTE Petition at 2-3; GTE Reply at 5-6; and Southwestern Opposition at 2-5.

[47] Bell Atlantic Reply at 10, n. 18; BellSouth Opposition at 5; Cincinnati Bell Petition at 10-11; Contel Reply at 8; and USTA Reply at 2-5, Ameritech advocates an actual use allocator for embedded plant only. Ameritech Petition at 12-13.

modernization of plant.[48] US Sprint argues that a shorter forecast period would ameliorate concerns about the punitive effect of retroactive reallocation of investment to nonregulated activities.[49] Ad Hoc argues that if cost allocation were viewed as an arm's length transaction, carriers would not allocate joint network costs to an arm's length provider of nonregulated services based on an analysis of extended depreciation lives.[50]

26. These parties caution, however, that very short forecast periods place too much investment risk on regulated services. Ad Hoc recommends a forecast period of five to seven years. The D.C. Commission advocates a period of five years or the life of the plant, whichever is shorter, although longer periods could be mandated if the carrier ". . . demonstrates a pattern of suspicious reallocation . . ." US Sprint states that a five year period should be adopted because it coincides with the length of time that an entrepreneur would typically select in planning a new activity.[51]

27. Several parties oppose any modification to the forecast period. CompuServe and IBM argue that suggestions to shorten the forecast period, as well as AT&T's actual use proposal, would result in an overallocation of spare capacity to regulated services because nonregulated use is not likely to peak in the first few years. CompuServe and IBM also argue that all businesses must make long-term capital recovery decisions, and that carriers should not be insulated from making similar long-term forecasts.[52] AT&T's actual use proposal should be rejected. IBM observes, because the actual use alternative was explicitly considered and rejected in the *Joint Cost Order*.[53] IBM also challenges AT&T's allegations that actual use would be simple to implement. Citing the Commission's *Order*, IBM says that an actual use allocator provides no guarantee that reallocation of costs will not be required at the conclusion of each study period.[54]

28. The Pennsylvania Consumer Advocate argues that long-term forecasting ensures that

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48 D.C. Commission Opposition at 4-5.

49 US Sprint Opposition at 3-5.

50 Ad Hoc Opposition at 20-21.

51 Ad Hoc Opposition at 20-21; D.C. Commission Opposition 4-5; and US Sprint Opposition at 3-5.

52 CompuServe Opposition at 10-13 and IBM Opposition at 3-8.

53 IBM Opposition at 5-6.

54 IBM Opposition at 6.

costs are allocated on the same basis as the carriers' fundamental planning decisions, and that the short-term forecasts described by the exchange carriers are merely incremental adjustments to long-term forecasts.[55] IDCMA states that a shorter forecast period will serve to place too much risk on regulated activities, and therefore amounts to a cross-subsidy from regulated services to nonregulated services.[56] MCI argues that the allocation structure created by this Commission, including the forecast period, should and does consistently err in favor of the ratepayer.[57]

29. On reply, the exchange carriers argue that those opposing changes to the allocation system have failed to provide adequate reasons to maintain the *status quo*. Bell Atlantic states that opponents have presented only "conclusory arguments," which fail to recognize that existing plant was constructed solely for regulated operations, and that ratepayers should pay these costs.[58] Bell Atlantic and BellSouth argue that suggestions to establish forecast periods of between five and seven years are arbitrary and lack a rational basis.[59] NYNEX claims that those opposing a change in the existing rules fail to recognize that the existing rules overallocate cost to nonregulated activities in each year except the peak year.[60]

30. Southwestern argues that if this Commission decides to retain a forecast methodology, we should shorten the forecast periods to correspond with actual planning periods and use a different allocator. Southwestern also disagrees with Pennsylvania Consumer Advocate's argument that short-term planning periods are merely adjustments to longer term investment cycles. Southwestern says the longer term studies are designed to evaluate the use of alternative technologies, and do not study demand and expansion requirements specifically. Once a technology is selected, a decision about installation is based upon the shorter planning cycles.[61]

31. In defense of actual use, AT&T and Southwestern argue that although experienced use

[55] Pennsylvania Consumer Advocate Opposition at 3-4.

[56] IDCMA Opposition at 8-11.

[57] MCI Opposition at 6-8.

[58] Bell Atlantic Reply at 7-10.

[59] Bell Atlantic Reply at 7-10 and BellSouth Reply at 4-5.

[60] NYNEX Reply at 3-5.

[61] Southwestern Reply at 4-6.

has already been rejected by this Commission, experienced use was never considered in conjunction with the reallocation provisions, which ensure that nonregulated operations bear their share of costs.[62] Southwestern states that the actual use method ultimately produce the same allocation as the forecasted use method and, therefore, does not overallocate cost to regulated operations.[63] AT&T also asserts that proponents of forecast periods ignore the complexities involved in the demand translation process.[64]

32. *Bifurcated treatment of embedded and new plant.* Two parties propose that embedded plant be treated differently from new plant in applying a forecast period. Ameritech argues that only one plant should be made subject to a forward-looking allocator, because only new plant will be installed for the purpose of providing both regulated and nonregulated use. Ameritech states that ratepayers should continue to bear the risk on all spare capacity associated with embedded plant.[65]

33. The Networks argue that embedded plant should only be made available for nonregulated use if offered pursuant to tariff, although the Networks would permit embedded plant costs to be reallocated to nonregulated activities if the embedded plant is no longer useful to regulated operations and reallocation would benefit nonregulated operations.[66]

34. Many parties oppose these proposals. Ad Hoc rejects Ameritech's proposal because it would fail to allocate any costs to new, nonregulated activities unless an asset used to provide a nonregulated activity were newly-installed. Ad Hoc observes that if the nonregulated activity were being provided by a third party vendor using carrier facilities, the carrier would almost certainly attribute some “cost” to the use of embedded equipment.[67] IDCMA argues that predicting peak nonregulated usage for embedded investment ought to be easier than predicting useage for new investment because historical usage information already exists for

[62]AT&T Opposition at 4-8; AT&T Reply at 7-8: and Southwestern Reply at 2-3.

[63]Southwestern Reply at 5-6.

[64]AT&T Reply at 7-8.

[65] Ameritech Petition at 9-13, Ameritech also advocates abandoning fully distributed costing in favor of a plan set forth by Ameritech in its comments leading up to the *Order* Ameritech Petition at 2-5. IDCMA opposes the argument as procedurally deficient. IDCMA Opposition at 3, n. 5. We agree that Ameritech has presented no new facts or arguments that warrant reconsideration.

[66]The Networks Opposition at 4-9.

[67] Ad Hoc Opposition at 24-25.

embedded plant.[68]

35. BellSouth says that there is no basis to distinguishing between embedded and new investment. BellSouth also argues that bifurcating the treatment of network plant in order to tariff all embedded plant will create obstacles to the use of the network.[69] NYNEX states that, in practice such a rule would be unworkable and unfairly discriminate on the basis of when an asset was placed in service.[70] Southwestern complains that issues about what is to be provided under tariff are *Computer III* implementation issues, not to be resolved in the *Joint Cost* proceeding.[71] USTA also disagrees with the Networks' proposal.[72]

b. Discussion

36. *Forward - looking allocators*. ln the *Joint Cost Order* we decided to continue the long-familiar practice of using relative use allocators to approximate cost-causative allocations of investment in common plant among plant users. We found, however, that in the case of telecommunications network plant, allocation between regulated and nonregulated services based on *actual* relative use would not be cost-causative because it would consistently underallocate investment risk to new and growing nonregulated services.

37. Two factors interact to produce this misallocation of investment risk: the lag between investment and demand, and the likelihood that new nonregulated network service will experience higher growth rates than established related services. Investment must be placed in anticipation of future demand, while actual use measurements are necessity measurements of historical use. Current investment intended for future use will, therefore, be properly allocated using an actual (historical) use allocator if and only if relative demand levels do not shift over time. In the case of regulated and nonregulated network services however, we believe that relative demand will shift dramatically over time because new nonregulated services will grow at a more rapid rate than established regulated services.

38. Carriers have argued strenuously that the increased modularity of the network has

[68]IDCMA Opposition at 11-12.

[69]BellSouth Reply at 6-7.

[70]NYNEX Reply at 5-6.

[71]Southwestern Reply at 10. Southwestern also argues that the Networks should have raised their tariff argument in a Petitions for Reconsideration. *Id.*

[72] USTA Reply at 6.

reduced the lag between investment and demand. None has demonstrated, however, that this lag has been eliminated for all of the types of equipment which make up a central office, or even for all of the investment categories likely to be involved in provision of enhanced services. Likewise, no party has presented us with any reason to doubt our assumption that nonregulated services will grow more rapidly the regulated services. We therefore decline to reconsider our determination that network plant investment must be allocated on a forward-looking basis.

39. In making this determination, we wish to emphasize the distinction between an actual use allocation method and the method we adopted, the peak relative nonregulated usage allocator subject to reallocation. Actual use entails allocating all current costs, including the cost of excess capacity installed in anticipation of nonregulated use, based on usage of network plant in the current period. Excess capacity costs caused by nonregulated activity may thus be borne in large measure by regulated activities. Peak relative nonregulated usage is an allocation method that operates to match costs with their causes by allocating capacity to those activities which caused the costs, in the form of excess capacity to be incurred. Making the forecast allocation subject to reallocation does not render peak relative nonregulated usage an actual use methodology. Reallocation requires carriers to calculate their cost allocations based on the ratio of regulated and nonregulated costs during the year in which nonregulated usage was greatest in comparison to regulated. Reallocation would therefore not produce the same allocation result as actual use.

40. *Shorter forecast periods.* In the *Order* we established "average depreciation life" as the period over which a carrier must forecast relative regulated and nonregulated usage because we viewed long-term forecasts as assuring the assignment to nonregulated activities of their full share of investment risk associated with existing and future network capacity. We believed that regardless of who uses it, network plant is installed based on a decision that its cost will eventually be recovered and that it will generate a profit. Depreciation life, which is a measure of an asset's useful life, is therefore a key determinant for deciding whether an asset should be installed.

41. After reviewing the pleadings submitted in response to our *Order*, we find that the practical problems associated with forecasting usage of network plant over the lengthy depreciation lives of most types of telephone plant require modification to our rules. Carriers cannot be expected to predict with any reasonable probability of accuracy what relative regulated and nonregulated usage will be 10, 15, 20 or more years from now. The longer the forecast period, the more likely that carriers will be engaging in guesswork to estimate usage trends. While we wish to require the correct allocation of investment risk, we should structure an allocation mechanism that relies less on fortune-telling and more on reasoned analyses. Furthermore, it is apparent that retaining "average depreciation life" as the general rule will lead to so great a variation in forecast periods used by carriers as to overcomplicate our

monitoring of cost allocations and seriously compromise our ability to make benchmark comparisons among the companies. Depreciation lives themselves vary from company to company. Over time, as carriers may be able to justify shorter forecast periods for particular categories of equipment, the variations could multiply. lt would become difficult to compare cost allocation results among companies even at high levels of aggregation.[73]

42. In light of these practical considerations, we are modifying our cost allocation rules to permit carriers to use uniform forecast periods of three years for all categories of central office equipment and outside plant. A detailed, specific, and convincing showing will be required to justify use of a planning cycle shorter than three years.

43. According to the majority of comments filed in this proceeding, three years is within the range of typical planning cycles for most types of network equipment. While some planning cycles are alleged to be longer or shorter, three years is the length of time most often cited as a period for which a reasonably accurate forecast can be performed. Carriers should therefore be able to predict with some degree of success, network usage by regulated and nonregulated activities. Use of a three-year period will allow carriers to rely on information generated from their budget planning process, as well as their engineering planning processes. Use of three-year forecast periods should also significantly reduce any misallocations that might occur with long forecast periods as a result of additional plant being installed during the period.

44. We recognize that expansion and modernization of some parts of the network may in fact be planned and deployed over a shorter period than three years. However, our modification to the length of the forecast period is not intended as a means of aligning the cost allocation standards to periodic decisions to install additional capacity. Our decision to reduce the length of the forecast was instead made for reasons of administrative convenience as well as practicality.[74]

45. If a carrier seeks to use a forecast period shorter than three years, we will require that a showing be made to justify the use of a shorter period. The showing must include the

[73] Comparability of cost allocation results is an important tool in our ability to monitor the cost allocation process for the exchange carriers. We have not, however, required strict uniformity in the cost allocation processes of the carriers, *See* Section (Vl)(B), *infra.*

[74] In electing a three-year period for forecasting usage, we re suggestions by some parties to set the forecast period at five years or more. We can find no persuasive rationalization for the section of a five-year period. By contrast, the three-year period. We have selected bears a substantial relationship to carriers' planning processes. In addition, we find little or no evidence or explanation offered by those opposing modification to the rules that would suggest that carriers can and do make meaningful longterm forecasts of usage extending to the full service life of an asset.

following elements: (a) proof that the relevant engineering planning period is less than three years; (b) a demonstration that the planning and deployment process is not merely the activation of capacity that is already in place but not yet in service; (c) a particularized demonstration that use of the shorter forecast period will result in substantially more accurate forecasts and therefore more accurate cost allocations; and (d) a demonstration that the overall costs of implementing the shorter forecast periods do not exceed the benefits. We recognize that the showing required to establish a forecast period of less than three years is extensive. However, we must have an adequate basis upon which to decide that shorter periods will in fact promote accurate cost allocations and thereby prove beneficial to the ratepayer. To do otherwise would be to adopt a regulatory mechanism that comes close to approximating the actual use allocation methodology. We have already rejected an actual use methodology because that methodology places network investment risk disproportionately on regulated activities.

46. *Bifurcated treatment of embedded and new plant.* We reject arguments that would have us distinguish between embedded and new network investment. There is simply no basis for treating identical items of network plant differently depending upon the time they were installed. Furthermore, as the carriers have noted, attempts to treat some plant differently from other plant would introduce a tremendous level of complexity into the tracking and auditing process that, for all practical purposes, would discourage joint use of network plant. We fail to see how ratepayers would benefit from such a result.[75]

2. Peak Relative Nonregulated Usage Allocator

a. Positions of the parties

47. Our cost allocation standards require that allocation of network plant investment be based on forecast relative use at the point during the forecast period when relative nonregulated use is expected to peak. A number of parties argue that peak relative nonregulated usage unfairly places too much investment risk on nonregulated activities. Other

[75] In addition, Western Union argues that the allocation of joint and common costs is a mechanism that can easily, but improperly, serve as a substitute for the *Computer III* requirement that requires carriers to obtain basic services for their own enhanced services at tariffed rates. Western Union states that this alleged "loophole" in the *Computer III* requirements will permit carriers to discriminate in favor of their own enhanced offerings by allocating costs of basic services instead of obtaining basic services under tariff Western Union Petition at 1-3 and Reply at 1-3. *See also* Ad Hoc Opposition at 23, n. 8. BellSouth and Southwestern Bell dispute Western Union's argument. BellSouth Opposition at 16 and Southwestern Opposition at 8-9. We agree with BellSouth that the terms of our *Order* are clear. If a basic service is offered under tariff to the public, a carrier providing enhanced services using the tariffed basic service must also obtain the basic service at its tariffed rate. *See* Section 64-901(b)(1) of the Commission's Rules, *printed in* 2 FCC Rcd at 1343.

allocation mechanisms have been proposed in its stead, each of which is alleged to balance the investment risk more fairly.

48. Noncoincident peak usage. The methodology most popular with petitioners is noncoincident peak usage. Like the allocator adopted in the *Order* noncoincident peak usage would produce an allocation between regulated and nonregulated costs based on relative use. Unlike the allocator adopted in the *Order,* both the point in time at which nonregulated usage peaks, and the point in time at which regulated usage peaks, are used to form the relative use ratio that allocates network costs between regulated and nonregulated activities. Noncoincident peak usage would generally produce a different ratio from that produced by peak relative nonregulated use, unless regulated and nonregulated usage peak in the same year within a forecast period.[76]

49. In support of noncoincident peak usage, BellSouth argues that the method we adopted could lead to anomalous results if regulated usage were to decrease unexpectedly in the same year that nonregulated usage peaks. Both BellSouth and SNET argue that a dip in actual regulated usage can give the appearance that the carrier has under forecast nonregulated usage, thereby triggering the real location provisions of the *Order.* They assert that, together with the application of a lengthy forecast period, the peak relative nonregulated usage allocator discourages common use of network plant.[77] USTA states that the rule as adopted "significantly" overallocates costs to nonregulated activities, thereby encouraging the provision of nonregulated service through separate facilities.[78] To derive the measure of nonregulated use pursuant to the noncoincident peak usage method, the peak nonregulated use must be divided by the sum of peak regulated use and peak nonregulated use. While USTA acknowledges that the sum of the two peak usage measurements may well represent any amount greater than 100 percent of network capacity USTA believes the relative use ratio that results is nonetheless valid.[79]

[76]BellSouth Petition at 14-16; SNET Petition at 15; Southwestern Bell Petition at 6-8; and USTA Petition at 10-15. Ameritech also states that noncoincident peak use is an acceptable allocation method although it favors a "discounted total relative demand" method. Ameritech Petition at 9-12.

[77]SNET Petition at 14-16; BellSouth Petition at 14-16; and BellSouth Opposition at 4-6, *See also* NYNEX Petition at 7-8 (hypothesizing a permanent decline in regulated usage) and Southwestern Petition at Appendix.

[78] USTA Petition at 13-15.

[79]For example, assuming a total capacity of 100 units, peak nonregulated usage of 30 units in one year and peak regulated usage of 90 units in another, the noncoincident peak use methodology would derive the relative use allocator by dividing the peak nonregulated use (30) by the sum of the peaks (30 + 90) for a nonregulated allocation of 25 percent. *See* USTA Petition at 15, n 19.

50. Those opposing a change to the allocator argue that the present method achieves our objective of protecting ratepayers. Ad Hoc argues that if this Commission modifies the length of the forecast period, then changes to the allocation mechanism are unnecessary.[80] IBM states that the existing method correctly recognizes incentives, and minimizes opportunities, to overallocate costs to regulated activities and should be retained.[81] The Networks argue that all the proposed changes to the allocator, including noncoincident peak use, will only serve to shield nonregulated activities from competitive risks.[82]

51. Average relative use. Several parties argue that the allocation between regulated and nonregulated activities ought to be based on average relative use of the network throughout the forecast period. AT&T states that if this Commission adheres to a forward-looking cost allocation system, we ought to employ average relative use as an allocator. AT&T argues that average relative use better reffects the use of plant installed early and late in the forecast period.[83]

52. NYNEX proposes to employ average relative use as part of an allocation system in which nonregulated costs are allocated by the higher of plant investment intended for the provision of nonregulated services or plant investment actually used or projected to be used on an average or relative peak basis by nonregulated services over a given planning period.[84] NYNEX also presents several arguments to support abandoning relative peak nonregulated usage. NYNEX states that by relying on the peak year, peak relative nonregulated usage overallocates costs to nonregulated activities in each year except the peak year. According to NYNEX, such an allocation mechanism violates fundamental principles of regulatory law because carriers will be prohibited from earning a rate of return on investment that should

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[80]For example, assuming a total capacity of 100 units, peak nonregulated usage of 30 units in one year and peak regulated usage of 90 units in another, the noncoincident peak use methodology would derive the relative use allocator by dividing the peak nonregulated use (30) by the sum of the peaks (30 + 90) for a nonregulated allocation of 25 percent. *See* USTA Petition at 15, n.

[81]IBM Opposition at 8-9.

[82] The Networks Opposition at 5-8.

[83]AT&T Petition at 15, n.* and AT&T Opposition at 3-4. n *****.

[84]NYNEX Petition at 14. Ad Hoc objects to NYNEX's proposal to alter the allocation mechanism. According to Ad Hoc, investment intended for nonregulated service will be directly assigned to the nonregulated side under our policy of maximizing attribution,and logically cannot be the basis for an allocator. Ad Hoc Opposition at 24.

properly be allocated to the regulated side.[85] NYNEX also argues that in adopting the peak relative nonregulated usage rule, this Commission has arbitrarily and capriciously disadvantaged nonregulated services and has failed to provide justification for that treatment. According to NYNEX, the adoption of a fully distributed costing mechanism by itself, in the absence of a peak relative nonregulated usage rule, is sufficient to promote an equitable sharing of joint and common costs. The fully distributed costing system, which seeks to maximize cost attribution, already burdens nonregulated activities with more cost than is necessary to prevent cross-subsidies. NYNEX accuses us of crafting a rule meant to approximate the costs of developing a standalone nonregulated business, an effort that NYNEX claim yields results which are "wholly hypothetical."[86]

b. Discussion

53. Noncoincident peak usage. The peak relative nonregulated usage allocator is one feature of a complex interwoven set of cost allocation standards that, when taken together, establish a balance of investment risk between ratepayers and nonregulated activities that we believe is necessary to meet our goals Modifications to any one of the features of the cost allocation plan significantly alter the breadth and depth of the investment risk faced by carriers embarking on nonregulated ventures. If less investment risk is imposed on nonregulated activities, the ratepayers bear more of the financial risk presented by unused network capacity Protecting the ratepayers from absorbing the investment risk for nonregulated activities is one of the chief tasks of this proceeding.

54. We decline to adopt noncoincident peak usage as an allocator for network plant.[87] We view as unlikely the hypothetical sets of facts presented by the parties in justification for amending the peak relative nonregulated usage rule. BellSouth, NYNEX, SNET, and Southwestern all posit situations in which regulated usage suffers a temporary or permanent

[85]NYNEX Petition at 5-9.

[86]NYNEX Petition at 9-13. NYNEX explains that while it does not object to the use of fully distributed costing, it does object to the peak relative nonregulated usage allocator. *Id.*

[87] We also decline to adopt alternate proposals to employ weighted averages or actual use. IBM suggests a weighted average allocator, but does not explain how the weighing process would work. IBM Opposition at 9. IBM's proposal is given support, but no further elucidation, by Southwestern and U S West. Southwestern Reply at 8 and U S West Reply at 5. We also reject proposals to base the allocation on actual use, consistent with our determination to affirm the use of forecast periods. *See* Ameritech Petition at 12-13 (advocating actual use for embedded investment only); AT&T Petition at 19-20; BellSouth Opposition at 5; Cincinnati Petition at 10-11; GTE Petition at 2-7; and Southwestern Opposition at 2-5. The proposals are opposed by The Network. The Networks Opposition at 5-8. *See also* IBM Opposition at 5-6.

decline. There is no basis to believe that regulated usage would decrease in the absence of a Commission decision deregulating a particular service, thereby transforming some regulated usage to nonregulated. Historically, regulated usage has continually increased and that growth has increased in the past several years.[88] Should this Commission decide to deregulate a service at a future date, accommodation can be made at that time for any adverse effects caused by the interaction of deregulation and the peak relative nonregulated use allocator.[89]

55. We believe that the peak relative nonregulated usage allocator, as modified in this reconsideration, provides the best solution for allocating investment risk between ratepayers and investors. The three-year forecast period should prevent carriers from engaging in guesswork that would have been required with use of a depreciable life forecast period. While it is uncertain whether the forecast obtained under a depreciable life method would have differed from those obtained under a three-year forecast we can be sure that the carriers will have a better opportunity to make an accurate forecast if they only need look ahead three years. As a result of this modification to our rules, we have decided that adoption of noncoincident peak usage is unnecessary and undesirable.

56. Average relative use. We do not find that the adoption of average relative use is required. The total amount of investment risk to be incurred is inextricably linked to the total amount of capacity that must be installed during the forecast period to meet total regulated and nonregulated demand. An allocator based on average relative use, while appearing to exhibit some equitable characteristics, fails to take into account the full scope of the risk to be incurred.

57. We also reject NYNEX's proposal to create a two part test for allocating usage. The first part of NYNEX's, proposal appears to allocate costs based solely on the carrier's subjective intentions in making plant investment, a test which is too difficult to verify. The second part of the test suggests an average use approach, which we have rejected for the reasons stated, *supra*. We also disagree that peak relative nonregulated usage violates fundamental concepts of regulatory law by denying recovery of costs that should be attributed to regulated activities. Our cost allocation mechanism, by employing peak relative non-regulated usage, reflects the total amount of investment risk to be incurred during the forecast period, and requires the nonregulated activity to bear its share of that risk. Simply because

[88] *See, e. g., MTS and WATS Market Structure,* 2 FCC Rcd 2953, 2954 (1987).

[89] We also find that the noncoincident peak proposal is flawed for the reason acknowledged by USTA. The proposal requires a calculation based on a total peak nonregulated and regulated capacity that will likely amount to more than a carrier's actual total capacity, an illogical basis from which to calculate an allocator. By creating an artificially large denominator, the resulting allocation factor is skewed to favor a carrier's nonregulated activities, by placing more of the joint and common costs on the regulated activities.

other allocation methodologies can be devised that allocate the risk differently does not mean that the method we have selected is confiscatory. Furthermore, in the unlikely event that some unusual circumstance, such as an unforeseen sharp drop in regulated use, were to trigger a retrospective reallocation to nonregulated activities of costs which had appropriately been borne by regulated services, the company would have the opportunity to demonstrate to us why the reallocation should not be required

3. **Reallocation of Plant Costs**

a. Positions of the parties

58. Reallocation requirements. Challenges have been: raised to virtually every aspect of our rules governing reallocation of network plant investment. A number of changes have been proposed that would substantially liberalize the requirements in the industry's favor BellSouth, for example, argues that carriers ought to be able to reallocate regulated investment to nonregulated activities without also reallocating prior costs and the time value of money if the carrier can demonstrate a regulatory demand for the capacity. BellSouth would therefore reallocate the investment at its current depreciated value. BellSouth complains that the reallocation provisions, together with the other aspects of the cost allocation standards, establish penalties that unfairly punish carriers for unintentional forecasting errors.[90]

59. Other carriers propose similar changes to the reallocation rule. NYNEX argues that reallocation of costs should be prospective, based on the depreciated baseline cost of network investment at the time it is reallocated. Furthermore, NYNEX would not discriminate between reallocations to nonregulated activities and reallocations to regulated activities. NYNEX states that its proposal avoids impermissible retroactive ratemaking should the transfer have the result of reducing regulated rates in the amount of the depreciation charge plus interest.[91] SNET objects to the payment of interest with the reallocated costs, arguing that the interest provision amounts to an unnecessary penalty.[92] Contel and USTA, like BellSouth and NYNEX, favor prospective reallocation of regulated investment to nonregulated activities,

[90] BellSouth Petition at 10-13 and BellSouth Opposition at 5-6. In the process of making its reallocation argument, BellSouth again raises the specter of a temporary or permanent drop in regulated use that could cause forecasted relative use to deviate from actual use, triggering a reallocation. For the reasons given, *supra*, we do not expect such phenomena to occur, and should a decline in regulated use take place, we will consider waiver petitions addressing the reallocation of prior costs and interest.

[91] NYNEX Petition at 15- 16. GTE also objects to the reallocation proposal. GTE Petition at 7-9.

[92] SNET Petition at 16.

excluding interest and depreciation.[93] Both Southwestern and USTA advocate the use of actual interstate rate of return instead of authorized rate of return, as a measure for calculating the reallocation rule. According to these parties, although carriers are not permitted to earn more than their authorized rates of return, they can and do earn less. By employing authorized interstate rate of return as the measure of interest due to the regulated activity for the time value of its money, these parties argue that ratepayers are very likely to receive a benefit in the form of a reallocation based on an authorized return greater than the actual return generated by the rates they paid.[94]

60. Several carriers argue that they should not be required to seek Commission approval prior to reallocating costs. Bell Atlantic argues that reallocations from nonregulated to regulated activities can be reviewed in the normal course of regulatory oversight.[95] BellSouth argues that reallocations from nonregulated use to regulated use ought not to require a waiver, and that carriers should simply be required to retain supporting documents to support the reallocations.[96] US Sprint, although not specifying its views on the waiver requirement, advocates permitting carriers to reallocate regulated costs to nonregulated activities at any time.[97]

61. IDCMA opposes plans to liberalize the reallocation rules. IDCMA asserts that the proposed changes only serve to encourage sloppy forecasting and would fail to guard against intentional misallocations. IDCMA argues that the actual rate of return for specific services is difficult to determine, and use of an overall rate of return is unacceptable. IDCMA also observes that if a competitive enterprise overestimates future demand, it will incur costs to rid itself of excess personnel or assets. IDCMA argues that a regulated enterprise ought not to be insulated from those same risks.[98] CompuServe also urges rejection of the proposed

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[93]Contel Petition at 9-10 and USTA Petition at 10-11. USTA would use the two-year rate of return period as basis for prospective reallocation of costs and would adjust the carrier's allocation annually each year. *USTA* would also exclude from nonregulated usage any usage taken under tariff. Usage taken under tariff would count as regulated usage for cost allocation purposes, even if used to provide a nonregulated service. *USTA* Petition at 16-17.

[94]USTA Petition at 15- 16, and Southwestern Petition at 8-9.

[95]Bell Atlantic Petition at 11, n. 23.

[96]BellSouth Opposition at 6.

[97]US Sprint Opposition at 4-6.

[98] IDCMA Opposition at 15-18.

modifications.[99]

62. Several parties urge us to impose requirements more severe than those required in the *Order.* IDCMA and CompuServe urge that plant-related expenses, such as taxes and maintenance, be included in the amount of investment reallocated. IDCMA and CompuServe also assert that a penalty charge in addition to interest should be imposed when reallocating costs from the regulated to the nonregulated side.[100] The carriers oppose these suggestions as unnecessary. According to the carriers, expenses are properly attributable based on current uses of plant, and the imposition of penalties is not needed.[101]

63. Level of nonregulated investment. NYNEX argues that the requirement that nonregulated investment not decrease from year to year amounts to an impermissible prohibition on increases in regulated investment. According to NYNEX, the fact that a waiver of this rule is available cannot serve to validate the rule.[102] In response to NYNEX's argument, Ad Hoc asserts that the rule prohibiting a decrease in nonregulated investment should be upheld, because it prohibits regulated entities from absorbing costs that are not "used and useful."[103] Southwestern and USTA do not challenge the rule, but request a clarification to make clear that a decrease in nonregulated investment does not preclude asset depreciation, retirement or impairments.[104]

b. Discussion

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[99] CompuServe Opposition at 13-14. In addition, AT&T argues that reallocation of costs from regulated to nonregulated must be made at fair market value or depreciated original cost, as required by *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C.Cir. 1973), *cert. denied*, 415 U.S. 935 (1974). Thus, suggestions to modify the reallocation provisions to exclude prior costs and interest should be rejected, according to AT&T. AT&T Petition at 20, n. * and AT&T Opposition at 6-7, n. ***. While our views on the *Democratic Central Committee* case are explored in detail, *infra*, it is our view that *Democratic Central Committee* has very limited application to cost allocation problems.

[100] IDCMA Petition at 16- 19; IDCMA Opposition at 16- 17; IDCMA Reply at 9-10; and CompuServe Opposition at 13-14.

[101] AT&T Opposition at 6-7, n. ***; Ameritech Opposition at 15-16; Bell Atlantic Opposition at 4-5; BellSouth Opposition at 6-7; NYNEX Opposition at 5-6; NYNEX Reply at 3, n. 5; Southwestern Opposition at 5-6; and USTA Opposition at 13.

[102] NYNEX Petition at 14-15.

[103] Ad Hoc Opposition at 14-16. *See Joint Cost Order, 2* FCC Rcd at 1320 and n. 284.

[104] Southwestern Petition at 9, n. 7 and USTA Petition at 17.

64. Reallocation from regulated to nonregulated activities. The cost reallocation requirements adopted in the *Order* serve to deter manipulative underforecasting of nonregulated usage and to mitigate the impact on ratepayers of unintended or unavoidable underforecasts.[105] If underforecasting of nonregulated usage occurs, a reallocation at undepreciated baseline cost plus interest causes the nonregulated activity to assume the costs that would have been allocated to it had the forecast been accurate. This protects ratepayers from underwriting the costs of unused capacity which is eventually used to meet unforeseen nonregulated demand. In short, the reallocation rules are essential to the integrity of a cost allocation system which requires cost allocations, like their associated investment decisions, to be made in anticipation of network usage, and which seeks to prevent regulated activities from absorbing nonregulated costs either at the start of a forecast period or subsequently.[106] No party has demonstrated that, in the absence of a reallocation requirement, carriers would not have every incentive to underforecast nonregulated use; that underforecasts are unlikely; or that reallocation both of the investment cost erroneously included in the rate base and of the return allowed on that investment is not necessary to make ratepayers whole. We therefore reject suggestions that we eliminate either the prior cost or interest component of the reallocation provisions.

65. The major objections to the reallocation requirements focus on the alleged unfairness of these requirements in light of the inability of carriers to forecast usage accurately over long periods of time. Because we have decided to reduce forecast periods to three years, carriers ought to be able to predict with a much greater degree of certainty the levels of regulated and nonregulated usage. We believe that the shorter forecast periods not only render moot the argument that it is somehow unfair to impose a remedy for underforecasting, but also make it

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[105] Reallocation is triggered when events demonstrate that the carrier has underforecast the ratio of nonregulated use to total use. Such an underforecast of relative nonregulated use might be the result of underforecasting the number of units of nonregulated use, overforecasting the number of units of regulated use, or a combination of these errors. For example, a carrier may forecast that peak nonregulated usage will be 10%, based on a forecast of 10 units nonregulated use and 90 units regulated use. If peak relative usage turns out to be 12 units nonregulated/90 units regulated, then 11.76% of costs should have been allocated to nonregulated use, and reallocation is required to produce the result that would have been obtained had the forecast been accurate. Similar results occur if peak relative usage turns out to be 10 nonregulated/88 regulated (10.2% nonregulated) or 11 nonregulated/89 regulated (11% nonregulated). As explained at para. *53, supra,* however, we consider it highly unlikely that significant reallocations will occur due primarily to an unforeseeable shortfall in regulated usage.

[106] USTA's reading of our *Order*, that basic services obtained at tariff rates should count toward regulated use even though they are used to provide nonregulated enhanced services, is the correct one.

much less likely that large-scale reallocations will ever become necessary.

66. We also reject suggestions to treat reallocations from nonregulated activities to regulated the same as reallocations in the opposite direction. An overestimation of nonregulated usage does not require ratepayers to bear the investment risk of the nonregulated activity's excess capacity No deterrent in the form of an interest provision is therefore required. We continue to believe, however, that Commission approval should be necessary to reallocate that excess capacity to the regulated activity in order to ensure that the reallocated capacity is required by the regulated activities of the carrier.[107]

67. Although BellSouth argues that we should differentiate between underforecasting that is intentional and that which is not, we have already rejected an exploration of a carrier's subjective intent in failing to allocate enough costs to a nonregulated activity. Regardless of the reason for the incorrect allocation, our task is to ensure that ratepayers do not underwrite the costs of nonregulated ventures. The reallocation mechanism we have employed merely serves to make the ratepayer whole with respect to the funds contributed to the reallocated network investment.[108]

68. We are also unpersuaded by arguments to base the interest payment on actual. not authorized. rate of return. In the *Litigation Expenses*[109] and *Rate of Return*[110] proceedings, we have explained that use of the authorized rate of return to calculate interest payments due to ratepayers reflects our decision to compensate ratepayers to the full extent of the benefits a carrier receives from revenues which, in the final analysis, it should not have earned. That reasoning is applicable here. Ratepayers may find themselves financing nonregulated ventures

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[107] *See Joint Cost Order,* 2 FCC Rcd at 1320 and n. 284. Approval is required for reallocation of excess nonregulated capacity to regulated use regardless of the reason why that excess capacity exists. Excess nonregulated capacity could result from an unanticipated decline of nonregulated services or from an anticipated decline in a nonregulated service after the point of peak nonregulated usage. A need to reallocate capacity originally intended for, and allocated to, future nonregulated use could also come about due to unanticipated regulated growth.

[108] While the reallocation provision is designed to deter cost misallocation, it does not, as BellSouth and SNET suggest, represent a penalty provision. The interest charges simply compensates the regulated activity (and its ratepayers) for the time value of money.

[109] Accounting for Judgments and Other Costs Associated with Antitrust Suits, 2 FCC Rcd 1341, 1347 (1987).

[110] Authorized Rates of Return for the Interstate Services of AT&T and the Exchange Companies, FCC 85-527 (released September 30, 1985), 50 Fed. Reg. 41350 (October 10, 1985) *aff' d in pertinent part* FCC 86-114, (released March 24, 1986) at pare. 57.

even after a cost reallocation has supposedly corrected the misallocation of costs, if the amount reallocated does not reflect the total cost of the funds employed by the regulated side.

69. *Level of nonregulated investment.* We reject NYNEX's argument that the rule prohibiting decreases in nonregulated investment is invalid. NYNEX's argument[111] that the prohibition on decreases in nonregulated investment prohibits increases in regulated investment is accurate only if total costs remain static. So long as to investment is increasing, regulated investment can increase as well. We therefore find no reason to overturn a rule, which ensures that investment will be allocated back on intended relative use instead of actual relative use.

70. Finally, we hereby clarify that the rule prohibiting decrease in nonregulated investment applies to gross book values and not net book costs. Therefore, the amount of depreciation associated with a given cost category is not at issue. With respect to impairments or retirements, we expect that additions to investment will be greater than retirements during the period when the nonregulated activity is growing. When the nonregulated activity is decreasing in size, the absolute amount of nonregulated investment is permitted to decrease.[112]

B. General Allocator

1. Background

71. The general allocator is used to allocate costs that cannot be allocated on the basis of cost causational factors such as relative use or relative time. Although direct and indirect mechanisms are preferred, use of the general locator recognizes that developing such an allocation system for some cost categories would be inherently difficult or excessively costly. We required that the general allocator be computed by using a ratio of all expense directly assigned or attributed to regulated and nonregulated activities.[113]

2. **Positions of the parties**

72. Most of the arguments concerning the general allocator urge us to expand or contract the range expenses used to derive the allocation factor. Ameritech, Bell Atlantic and USTA

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[111] In the event costs are predicted to decrease or are decreasing, the *Order* provides that the attribution factor for the affected cost category will be frozen at the level that applied during the period in which total demand peaked. *See Joint Cost Order* at 1320.

[112] *Id.*

[113] Joint *Cost Order,* FCC Rcd at 1318.

argue that if the allocator is based on expenses, it ought to exclude the "cost of goods sold." Cost of goods sold refers to goods held in inventory for resale. While the goods remain in inventory, the value is recorded as a corporate asset; when sold, their value is recorded as an expense. According to the carriers, customer premises equipment (CPE) is given "cost of goods sold" accounting treatment.[114] USTA argues that the components of the CPE expense -- acquisition, transportation, and warehousing costs -- have little to do with general corporate overhead, and therefore are poor indicators include in the general allocator.[115]

73. Ad Hoc, AT&T and IDCMA disagree Ad Hoc states that CPE expenses are no different from any other expense, in that they are generally passed through to the prices charged to the consumer.[116] IDCMA further argue that as long as the depreciation expense for purchased equipment remains in the general allocator, so should the cost of goods sold.[117]

74. IDCMA suggests excluding appreciation expense from the general allocator because it is an expense which is inextricably linked to assets, a factor which was specifically excluded from the computation of the general locator.[118] That suggestion is strongly opposed by the industry. The carriers argue that depreciation expense is legitimate business expense that should be included in the allocator.[119]

75. Two carriers contend that the factors which determine the general allocator ought to be expanded. SNET argues that, contrary to the stated rationale of the Order, multiple-factor allocators are easy to administer and provide more accurate results. SNET and Contel also argue that an expense-based allocator will tend to overallocate costs to nonregulated activities, which are more expense-intensive than regulated activities.[120] Ad Hoc, AT&T, and NYNEX

[114] Ameritech Petition at 16-17; Bell Atlantic Opposition at 4; n. 8; USTA Petition at 19-22. Ameritech argues that the BOCs' Shared Administrative Services Plans, submitted pursuant to the *Computer 1I* proceeding, excluded cost of goods sold from the general allocation factors. SNET also supports excluding cost of goods sold. SNET Petition at 6, n. 11.

[115]USTA Petition at 19-22.

[116] Ad Hoc Opposition at 17-19. *See also* AT&T Opposition 1-2, n. *.

[117] IDCMA Opposition at 18- 19.

[118]IDCMA Petition at 12-13 and Reply at 7-8.

[119] AT&T Opposition at 1-2, n.*; Ameritech Opposition 12-13; Bell Atlantic Opposition at 3-4; BellSouth Opposition 14-15; NYNEX Opposition at 6-7; Southwestern Opposition 7-8; and USTA Opposition at 11.

[120]SNET Petition at 4-6; SNET Reply at 5-6; and Contel Petition at 7, n. 2.

oppose use of a multiple-factor allocator, because application of multiple factors can lead to double-counting of some indicators.[121]

76. In addition, IDCMA would limit the use of the allocator to five percent of a company's total costs, a requirement opposed by the industry as arbitrary and unnecessary.[122]

77. Finally, two petitioners propose modifications of the time period for measuring expenses. At present, the *Order* provides that carriers use current expenses. AT&T argues that use of current expenses presents administrative difficulties, because all expenses for the current month will have to be recorded before the general allocator can be derived and applied to the various cost categories. Thus, the allocation process will be substantially delayed. Furthermore, AT&T says that expense data can experience dramatic shifts from one month to the next. AT&T suggests use of prior year's expenses, updated quarterly. IDCMA suggests using a "rolling three months" period. IDCMA's proposal is opposed by AT&T, arguing that use of a "rolling three months" will fail to solve the administrative problems presented by use of a current expense ratio.[123]

3. **Discussion**

78. "Cost of goods sold," when it is used in the sense of items purchased for resale, should be excluded from the expenses that contribute to the derivation of the general allocator. Other costs, such as those incurred to obtain the inventory, manage it, or dispose of it, are ordinary operating expenses that should be included in the general allocator. We do not believe that cost of goods sold bears any relationship to the type of operating expense we had in mind in fashioning the general allocator.[124]

79. We will also reject IDCMA's proposal to exclude depreciation expenses from the expenses used to derive the general allocator. Depreciation expenses are a recognized, legitimate expense of doing business. As an estimate of how much of the value of an asset is

[121] Ad Hoc Opposition at 18-19; AT&T Opposition at 1-2, n.*; NYNEX Opposition at 6-7.

[122] IDCMA Petition at 13-14; IDCMA Reply at 8-9; Ameritech Opposition at 13-14; BellSouth Opposition at 15-16; Southwest Opposition at 6-7; and USTA Opposition at 11-12.

[123] AT&T Petition at 21-23; AT&T Reply at 2, n. *; IDCMA Opposition at 20.

[124] A different situation is presented in accounting for "cost goods sold" in a manufacturing operation. In that case, "cost goods sold" includes many operating costs that legitimately belong in the general allocator. Therefore, cost of goods sold, when used to account for a manufacturing operation, should be included in the expenses that determine the general allocator.

"consumed" during a given period, depreciation expenses apply to both regulated and unregulated activities. They are no more linked to assets than many other types of expenses, such as expenses for maintenance or repair.

80. We will also reject SNET's and Contel's proposal to expand the factors that are used to compute the general allocator. As we stated in the *Order*, use of multiple factors is complicated and will provide no significant improvement from an allocator based solely on expense.

81. Furthermore, we decline to impose a limit on the amount of total company expenses to be allocated pursuant to the general allocator, as IDCMA suggests. Our *Order* clearly expressed our expectation that carriers would first attempt to allocate costs directly, and if no direct basis could be found, to use some indirect measure. Only if no direct or indirect allocation device could be found would carriers be permitted to use the general allocator. Through the cost manual review process, we will enforce our cost allocation mechanisms proposed for the various cost categories. IDCMA and others will, at that time, have opportunities to challenge any inappropriate use of the general allocator.

82. The objections raised to basing the general allocator on the current month's data have persuaded us that difficult administrative problems exist that will delay the cost allocation process. Because cost allocation is a process that must be completed prior to separation of state and interstate regulated costs, which in turn is a prerequisite to the calculation of interstate access charges, a delay that would affect these other regulatory mechanisms is highly undesirable. We therefore find that use of prior expense data is the better method of developing the general allocator.

83. AT&T's proposal, to use prior year's data updated quarterly, would appear to produce skewed results in an environment in which nonregulated services offered through the network are expected to grow dramatically. Use of last year's data would consistently understate non-regulated usage. However, IDCMA's proposal to use a "rolling three month" period does not avoid the problems associated with use of current data. We nevertheless agree that use of a quarterly measure will better reflect nonregulated growth trends. Carriers should base the allocator on quarterly data collected in the three-month period ending two months before the current month. The two month gap between the current month and the close of the rolling quarter should avoid the administrative difficulties that use of a current allocator would have presented by providing ample time for carriers to record their expenses before developing and applying the general allocator. lt should also avoid dramatic understatement of the expenses devoted to nonregulated investment.

C. Employee Time Reporting

1. Background

84. In the *Joint Cost Order,* we decided against mandating that all employee time be recorded pursuant to a single reporting method. After evaluating the merits of the two principal time reporting methods positive-- time reporting and exception time reporting -- we found that both possess advantages and disadvantages.[125] We decided to permit carriers to use whichever method best fit the nature of the employee's responsibilities, subject to our continuing oversight and general guidelines concerning time reporting. We were especially concerned that time not reported or nonproductive time not be disproportionately designated to regulated activities.

85. To prevent misallocation, we mandated the following: (1) cost manuals must contain a description of the methods used to teach, monitor and enforce accurate time reporting; (2) time can be reported in increments of no more than one hour; (3) carriers must retain for one year time records for maintenance and sales personnel, along with other supervising records of employee assignments, in order to establish an auditable record of employee time; and (4) cost manuals must contain a description of the reporting method for nonproductive time, and documentation relating to the reporting of nonproductive time must also be arranged.[126]

2. Positions of the parties

86. IDCMA challenges our general guidelines and requirements for employee time reporting, citing issues which it previously raised in its comments. IDCMA believes that this Commission should mandate positive time reporting in increments of 15 minutes or less. According to IDCMA, use of the exception time method by marketing, sales, systems, engineering and service departments creates opportunities for carriers to treat all nonproductive time as regulated. IDCMA suggests that all nonproductive time be recorded as nonregulated. Furthermore, additional reporting requirements should be mandated to ensure accuracy in the time reporting process.[127]

87. A number of carriers oppose IDCMA's suggestions on the grounds that the issues raised were decided in the *Order* and no new information has been provided that compels

[125]Positive time reporting involves dividing an employee's work day into uniform increments of time and requiring the employee to account for each increment. Exception time reporting assumes that an employee is assigned to routine job functions, unless the employee reports differently.

[126]Joint Cost Order, FCC Rcd at 1321-22.

[127]IDCMA Petition at 7-11 and Reply at 4-6.

reconsideration. The carriers also state that some flexibility in reporting mechanisms is needed if employee time reporting is to remain accurate.[128]

88. In addition to IDCMA's concerns, US Sprint argues that we should require that carriers retain records relating to employee time for one year beyond the close of the fiscal year to which the records relate or, alternatively, one year from the submission of the auditor's report to this Commission. Currently, records need only be kept one year, a requirement that US Sprint states may interfere with auditability. US Sprint's position is supported by several other parties, while IDCMA argues that records should be kept three to five years.[129]

3. Discussion

89. With the exception of adopting US Sprint's proposed modification to clarify how long records should be retained, we will not adopt the proposed changes to our requirements for employee time reporting. IDCMA has raised no new issues that warrant reconsideration. As we have stated in our *Order,* both positive time reporting and exception time reporting have strengths and weaknesses which render them more or less valuable in a given work environment. One system will not accommodate all needs. Further, by requiring retention of records sufficient to follow an audit trail we can monitor the implementation of time reporting systems through the annual audit process.

90. We adopt US Sprint's proposal to require record retention for at least one year after the close of the fiscal year to which records relate Adoption of this proposal will ensure that records are retained long enough for the completion of the annual audit.[130] We decline, however, to adopt IDCMA's suggestion to retain records for three to five years. Retention of records for that length of time is unnecessary.

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[128] Ameritech Opposition at 9-11; Bell Atlantic Opposition 5-6; BellSouth Opposition at 12; NYNEX Opposition at 3-4Pacific Companies Opposition at 7-8; Southwestern Opposition 10-12; and USTA Opposition at 10.

[129] US Sprint Petition at 2-3; AT&T Opposition at 7, n.**; BellSouth Opposition at 12; and IDCMA Petition at 11-12. Two parties oppose IDCMA's suggestion. *See* Pacific Companies position at 8 and Southwestern Opposition at 12.

[130] Our finding is made pursuant to Section 42.4 of the Commission's Rules, which provides the Commission " . . . shall reserve the right to add records, or lengthen retention periods upon finding that retention periods may be insufficient for its regulatory purpose." Revision of Part 42, Preservation of Records of Communication Common Carriers, CC Docket No. 84-283 FCC 86-367, released August 22, 1986.

IV. AFFILIATE TRANSACTIONS

91. In addition to adopting cost allocation standards, the *Joint Cost Order* established rules for the transfer of assets and the provision of services between carriers and their affiliates. The affiliate transactions rules are intended to prevent cost shifting by means of improper transfer pricing. In formulating the rules, we decided to distinguish between transactions for assets and transactions for services due to the unique considerations presented by each type of transfer.[131] The rules were incorporated as part of both the existing and revised USOA.[132]

A. Valuation of Assets Transferred Between Affiliates

1. Background

92. The *Order* adopted a general rule requiring all assets transferred between affiliates to be valued at the currently effective tariff rate or at the price as determined by prevailing price list held out to the general public in the normal course of business. We found that these two valuation methods provided reasonable assurance that the price of the assets transferred would not be manipulated to the detriment of ratepayers. If neither of these two valuation mechanisms is available, we found that asset transfers should be valued under the following rule: asset transferred out of regulation should be valued at the higher of net book cost or fair market value, while asset transferred into regulation should be valued at the lower of net book cost or fair market value. Thus, if a tariff or price list rate were not available, ratepayers would be protected both from danger of rate base inflation by means of overpricing assets sold to the regulated company and from the possibility of subsidizing a nonregulated affiliate through below-cost transfer prices. These same affiliate transactions rules were applied to transfers b tween carrier's regulated and nonregulated accounts.[133]

93. We also found that our resolution of the issue presented by affiliate transactions was fully consistent with the principles expressed in *Democratic Central Committee.* That case involved the distribution of gains from assets transferred out of regulation.[134] The Court of Appeals held that ratepayers are entitled to the gains realized upon the transfer of utility

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[131] *Joint Cost Order*, FCC Rcd at 1335-36.

[132] See Section 31.01-11 and Section 32.27 of the Commission Rules, 2 FCC Rcd at 1342-44, *to be codified at* 47 C.F.R. §§31.01- 11 and 32.27.

[133] 2 FCC Rcd at 1336.

[134] *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973), *cert denied 415* U.S. 935 (1974).

property out of the rate base if the ratepayers bore the risk of loss on that property while it was under regulation.[135]

2. **Positions of the parties**

94. The residual valuation rules. Many of the carriers argue that the affiliate transaction rules, as adopted, are contrary to the requirements of *Democratic Central Committee* Most of the objections focus on the residual rule which govern valuation in the absence of a tariff or price list.

95. AT&T argues that we have misinterpreted *Democratic Central Committee* to apply only to situations in which a carrier is transferring an asset out of regulation rather than applying the equitable principle established in the case to all types of transfer activities AT&T interprets the Court's opinion as establishing the principle that the right to gain on utility assets follows the risk of loss on those assets.[136] According to AT&T, the application of the principle requires that one must actually bear a risk in order to receive a gain. In the normal regulatory scheme, AT&T argues, it is the ratepayers who bear the risk of loss on regulated assets. AT&T argues that the residual affiliate transaction rules invert the normal regulatory relationships, because ratepayers become insulated from loss while shareholders lose the opportunity for full recovery of their investment.[137]

96. BellSouth and GTE argue that, if ratepayers are insulated from loss while shareholders lose the opportunity for full recovery, then the affiliate transaction rule fail to balance shareholder and ratepayer interests pursuant to *Democratic Central Committee.*[138] Southwestern alleges that we should have engaged in a factual inquiry into which group bore the risk of loss, as the *Democratic Central Committee* court did.[139]

97. NYNEX argues that a regulated entity must be allowed to obtain rate recognition of

[135]485 F.2d at 808-12.

[136] AT&T Petition at 3-5 and Reply at 2-4.

[137]AT&T Petition at 5-11. A number of carriers made similar arguments. *See* BellSouth Petition at 16-21; BellSouth Opposition at 7-8; BellSouth Reply at 7-9; GTE Petition at 10-21; GTE Reply at 6-8; NYNEX Petition at 16-23; SNET Petition at 7-10; SNET Reply at 3-4; Southwestern Petition at 10- 15; Southwestern Reply at 10-17: and U S West Petition at 5- 13.

[138] BellSouth Opposition at 7-8; GTE Petition at 14-21; and GTE Reply at 6-8.

[139]Southwestern Petition at 10-15 and Reply at 15-17.

the costs it incurred to obtain an asset from an affiliate at a fair market price, even if the fair market purchase price was above the affiliate's net book cost. Similarly, NYNEX argues, it is "clear legal error" to require a regulated entity to record a sale to nonregulated entity at net book cost when net book exceeds fair market value. NYNEX states that both *Democratic Central Committee* and cases decided by this Commission preclude shareholders from bearing the risk of loss when an asset is transferred to an affiliate at a price above fair market value.[140]

98. Carriers raise a number of additional objections to the rule. AT&T, Ameritech, NYNEX, SNET, and Southwestern assert that the rule will discourage intracorporate transactions. and will force carriers to buy from or sell to outside parties.[141] AT&T argues that the rule fails to reflect the reality that investors always bear the risk on nonregulated investment.[142] Ameritech and U S West argue that it is unfair to require some transfers to occur at net book cost because, for carriers, net book has been artificially inflated by less-than-adequate depreciation rates.[143] Southwestern alleges that this Commission does not have the jurisdiction to penalize a carrier for lawful, fair market value transactions, and cannot create a rule for the purpose of avoiding inconvenient investigations into individual transfers.[144] BellSouth argues that the rules operate as a subsidy for the regulated activity. Subsidies are inconsistent with the highly competitive nature of nonregulated enterprises, BellSouth argues, and would therefore have the effect of creating incentives for carriers to avoid affiliate transactions in favor of third party transactions.[145]

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[140]NYNEX Petition at 16-23. AT&T uses the example of an asset transferred from a carrier to an affiliate at the net book value, assuming the fair market value to be less than net book. AT&T observes that, even though the rule requires the carrier to transfer the asset at its net book price, the affiliate will nonetheless record the asset's fair market value on its books. Because the entire investment will have been removed from the carrier's books, investors will have no opportunity to recover from ratepayers the shortfall between the net book price and fair market value. *AT&T* argues that the inability of investors to recover full net book value of their investments violates *Democratic Central Committee*, as well as previous Commission decisions finding that ratepayers bear the risk of loss on a sale at less than net book value. AT&T Petition at 5-10.

[141]AT&T Petition at 5-10; Ameritech Petition at 13-16, Bell Atlantic Petition at 3-6; Bell Atlantic Reply at 3-10; NYNEX Petition at 21-23; SNET Reply at 3-4; and Southwestern Reply at 15- 16.

[142]AT&T Petition at 10-11. AT&T also argues that structuring a transfer rule around a nonregulated entity's net book cost is erroneous because net book values in nonregulated enterprises are meaningless.

[143]Ameritech Petition at 13-15 and U S West Petition at 5-10.

[144]Southwestern Reply at 16.

[145]BellSouth Petition at 16-21. *See also* Bell Atlantic Reply at 3-10.

99. The carriers adopt the view that *Democratic Central Committee* requires all assets to be transferred at fair market value, whether they are being moved into or out of regulation.[146] If fair market value cannot readily be ascertained, then carriers favor using net book value as a surrogate.[147] NYNEX argues that fair market value adequately protects ratepayers from artificial manipulation of asset prices because the regulated entity is prevented from selling the asset to its affiliate at a low price, only to repurchase the asset at a high price.[148] SNET argues that the annual audits are sufficient to protect ratepayers.[149] Ameritech argues that existing state regulation will discourage abusive transfer practices.[150]

100. Various parties oppose any changes to the affiliate transaction rules. Ad Hoc and IDCMA argue that this Commission's obligation under *Democratic Central Committee is* to protect ratepayers, which is what the asset transfer rule accomplishes.[151] The Networks, CompuServe, and MCI assert that carriers are always free to conduct transactions with non-affiliates. According to these parties, suggestions that the transfer rules "force" a price on carriers or their affiliates are misleading.[152] These parties argue that neither auditing nor

[146] AT&T Petition at 11; Ameritech Petition at 13-16; Bell Atlantic Petition at 3-6; BellSouth Petition at 20-21; BellSouth Opposition at 8; BellSouth Reply at 9; GTE Petition at 21; GTE Reply at 8; NYNEX Petition at 21 -23; SNET Petition at 7-9; Southwestern at 15-16; USTA Petition at 5-7; USTA Opposition at 7-8; U S West Petition at 10; and U S West Reply at 7-8.

[147] Bell Atlantic Petition at 3-6; BellSouth Petition at 16-21; BellSouth Opposition at 8; BellSouth Reply at 9; NYNEX Petition at 16-21; and SNET Petition at 7-9. USTA advocates use of "cost" as an alternative standard if fair market value cannot be determined. USTA Petition at 5-7 and Opposition at 7-8.

[148] NYNEX Petition at 21-23.

[149] SNET Petition at 7-9

[150] Ameritech Petition at 13-16.

[151] Ad Hoc Opposition at 9-11; IDCMA Opposition at 4-7; and US Sprint Opposition at 6-10. Ad Hoc also argues that the asset transfer rule for transfers into regulation is consistent with the operation of the Generally Accepted Accounting Principles (GAAP), which would govern accounting for transfers to unaffiliated entities. Ad Hoc Opposition at 11-13. This argument is contested by AT&T, USTA and U S West, who argue that the relationship between net book and market value is different under regulation than it is under GAAP. AT&T Reply at 4-5, n. ***; USTA Reply at 5, n. 16; and U S West Reply at 6-7. *See also* Southwestern Reply at 15, n. 21. Ad Hoc's argument is unpersuasive. Under GAAP, acquisitions are initially recorded by the acquiring party on the basis of cost, not on the basis of the lower of net book value or fair market value.

[152] CompuServe Opposition at 6-9.

state regulation can take the place of affiliate transaction rules.[153]

101. The Networks and IDCMA urge us to affirm our reading of *Democratic Central Committee.* They argue that *Democratic Central Committee is* not an affiliated transactions case and cannot be blindly applied to affiliated transaction problems.[154] CompuServe states that *Democratic Central Committee* should simply be read for the proposition that the interests of ratepayers and shareholders must be taken into account in distributing profit from a sale.[155] US Sprint argues that attempts to read *Democratic Central Committee* to apply to transfers from a nonregulated entity to a carrier are incorrect and rely solely on *dicta* concerning an issue that was not before the court.[156]

102. In addition, the D.C. Commission argues that affiliate transactions have always been an area of concern to regulators, but that the states have lacked effective regulatory power due to their inability to regulate holding companies. The D.C. Commission would retain the rules as adopted because the rules benefit ratepayers.[157]

103. In response, carriers contest the argument that the rules should be upheld because they do not compel carriers to deal with affiliates. By creating incentives to deal with third parties, carriers argue, this Commission is imposing needless transaction costs and creating uncertainty as to whether some transfers will be disallowed.[158]

104. AT&T argues that, contrary to the narrow reading of *Democratic Central Committee* advocated by some parties, the case does involve valuation of assets and therefore has application to the affiliate transaction rules.[159] BellSouth argues that the case is grounded in equity, and its holding has broad application.[160] According to NYNEX, it has long been held

[153]The Networks Opposition at 9-11; CompuServe Opposition at 3-7; MCI Opposition at 5-6; and US Sprint Opposition at 6-10.

[154]The Networks Opposition at 9-11 and IDCMA Opposition at 4-7.

[155]CompuServe Opposition at 7. n. 16.

[156]US Sprint Opposition at 6- 10.

[157]D.C. Commission Opposition at 2-4.

[158]AT&T Reply at 5-6 and n. *** and Bell Atlantic Reply at 3-10. *See also* BellSouth Reply at 7-8.

[159]AT&T Reply at 3, n. **.

[160]BellSouth Reply at 7-8.

that ratepayers are not entitled to the gain on property for which the shareholders have borne the risk of loss, a tenet which is ignored in the *Order.*[161] Southwestern similarly disagrees with a narrow reading of the case, urging us to focus on the broad equitable principles that are the basis for the court's decision.[162]

105. *Expanded definition of market value.* Several carriers argue that the rule requiring asset values to be established by reference to a tariff or price list is unnecessarily restrictive. Bell Atlantic notes that we have recognized that many valuation techniques beyond tariff prices and price lists can be accurate indicators of fair market value, but these other methods can only be used in the context of comparing net book value to fair market value when a tariff or price list does not exist. According to Bell Atlantic, suggestions that fair market value will be difficult to determine in the absence of a tariff or price list are wrong since this Commission always requires other methods to be employed as part of the residual rule.[163] Southwestern and USTA also argue that use of price lists and tariffs are too narrow for determining fair market value. USTA urges us to adopt a number of other criteria that should be considered in reaching a fair market value determination.[164]

106. The Pennsylvania Consumer Counsel objects to these proposed changes due to the problems inherent in providing meaningful regulatory oversight of individual carrier transactions. In addition to being difficult to audit, broader criteria for market price make it far more difficult to ascertain if the price charged was correct.[165]

107. In addition to arguments for or against expansion of the "fair market value" definition, BellSouth argues that we ought to abolish the waiver procedure which is currently a prerequisite to use of an alternate valuation measure. BellSouth asserts that this Commission

[161] NYNEX Reply at 6-7.

[162] Southwestern Reply at 10-14. *See also* USTA Reply at 6-7.

[163] Bell Atlantic Petition at 3-6, citing *Joint Cost Order* at 1336 and n. 469; and Bell Atlantic Reply at 3-10. *See also* NYNEX Reply at 9.

[164] Southwestern Petition at 10, n. 8 and USTA Petition at 2. If we affirm our rules as adopted, NYNEX asks that net bond price transfers from nonregulated affiliates to carriers include the reasonable cost of capital if the affiliate's business is the provision of assets. NYNEX also requests that a nonregulated affiliate price list be used in lieu of net book to establish value if the affiliate is "legally foreclosed" from selling assets to the general public and the prices listed are reasonable in comparison to market prices. NYNEX Petition at 23.

[165] Pennsylvania Consumer Advocate Opposition at 1-2.

already monitors this area through its audit requirements.[166] The Networks agree that there might be circumstances in which a waiver should be granted for a carrier to price an asset at less than what would be required by the *Order*, although the Networks would have a carrier demonstrate that the regulated business is not subsidizing the nonregulated, that ratepayers will benefit, and that the asset has already been refused by potential nonaffiliated buyers.[167]

108. *Application to specific transactions.* Finally, three carriers argue that the affiliate transaction rules ought not to apply to certain types of transactions. Bell Atlantic argues that for transfers between accounts, it may prove difficult to determine fair market value of the asset transferred. Bell Atlantic states that in these circumstances, net book cost should be mandated as the transfer value.[168] BellSouth and U S West request a "clarification" that the rules do not apply to transactions between two regulated affiliates.[169]

3. **Discussion**

109. *The residual valuation rules.* The decision to adopt affiliate transaction rules as part of this cost allocation proceeding stemmed from our desire to create a mechanism which eliminated the ability of carriers to shift the investment risk of nonregulated activities to the regulated entity and its ratepayers. Adoption of the cost allocation standards alone would have been insufficient to achieve this objective. Because the cost allocation standards protect ratepayers through such features as fully distributed costing and a forward-looking allocation of network plant investment, they create incentives for carriers to seek a means of avoiding the cost allocation process, and the investment risk balance it presents.[170] One obvious mechanism for altering the investment risk balance is by resort to affiliate transactions in which the carrier provides an asset or service at a rate below its cost, or obtains an asset or service at a rate above its affiliate's cost. In this manner, a carrier and its nonregulated affiliate can shift not only the cost of nonregulated activities, but also their investment risk, to the regulated carrier. It is this potential problem that the affiliate transaction rules are intended to prevent.

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[166] BellSouth Petition at 21-22.

[167] The Networks Opposition at 11- 12.

[168] Bell Atlantic Petition at 6, n. 13.

[169] BellSouth Petition at 22-23 and U S West Opposition at 4-6.

[170] This is particularly true in the case of services shared between regulated and nonregulated activities. To avoid the cost allocation rules, a carrier could simply place services in a separate subsidiary and proceed to charge the regulated and nonregulated activities in a manner disadvantageous to ratepayers.

110. The bulk of the comments challenging the affiliate transaction rules focus on the portion of the rules governing transactions of assets for which no tariff price or price list exists.[171] Of the various arguments concerning why the rules should be modified, the majority assert that the rules violate the standards set forth in Democratic Central Committee.[172] After careful review of the legal and policy arguments set forth by the parties, we find that the rules as adopted are fully consistent with the requirements of *Democratic Central Committee* and this Commission's previous interpretations of that case.

111. *Democratic Central Committee* concerned the distribution of capital gains on property that had been transferred out of the rate base. The property at issue included former railway terminals and repair shops that had substantially appreciated in value, but which were no longer required as a result of conversion to an all-bus system. The Washington Metropolitan Area Transit Commission had rejected arguments to take into account the capital gains in establishing a new schedule of fares for the D.C. Transit System. The court ruled that ratepayers, who were forced to bear the burden of the extraordinary costs associated with the conversion, should be entitled to the gains, to the extent there were any, generated from the conversion.[173]

112. In reaching its decision, the court relied upon two separate but overlapping principles it distilled from antecedent case law. The first principle is that the right to gain follows the risk of loss. The second is that economic benefits must follow economic burdens.[174] The Court conducted a factual inquiry into the relationships of ratepayers and shareholders to the property transferred, and concluded that while there had not been much risk loss on the property at issue, ratepayers had borne economic burden in the conversion to an all-bus transit system. Ratepayers were therefore entitled to the capital gains on the property because the conversion was the reason the railway property had been transferred, thereby generating a capital gain.[175]

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[171] *See* Section 31.01-11(b) and (c) and Section 32.27(b) and (c), 2 FCC Rcd at 1342, 1345, *to be codified at* 47 C.F.R. §§ 31.01-11(b) and (c) and 32.27(b) and (c).

[172] 485 F.2d 786 (D.C.Cir. 1973). *Democratic Central Committee* was one of the first efforts by a reviewing court to evaluate in detail how a regulatory agency responded to a utility's actions in removing assets from regulated service. This Commission has often examined that opinion for guidance in reviewing asset transfers out of regulation. *See, e. g., Detariffing of CPE,* 95 FCC 2d 1276, 1312- 19 (1983).

[173] 485 F.2d at 812- 13.

[174] *Id.* at 807-08.

[175] *Id.* at 821-22.

113. A few observations about the case are necessary to understand our interpretation of it. *Democratic Central Committee* is not a case involving the valuation of assets.[176] The property had already been transferred to below the line accounts, and some of it had been sold at market value. The case instead focuses on the distribution of capital gains that had already been realized from the transfer or sale. In addition, *Democratic Central Committee* is not a case concerning affiliate transactions. The case involves a transfer of property to below the line accounts and the subsequent sale of that property to third parties. In relying on the case as a guide for fashioning affiliate transaction rules, we have recognized that *Democratic Central Committee,* while supplying us with some general principles, does not provide a complete road map for avoiding the potential pitfalls that could occur if affiliates attempt to manipulate asset values to the detriment of rate payers .

114. We do not believe, as some carriers suggest, the our reading of *Democratic Central Committee* has been overly narrow or concentrated on the facts. The equitable principles identified in the case have direct application to a transfer of assets out of regulation that produces gains to be distributed. In accordance with the case, the residual affiliate transaction rules assure that ratepayers receive the gains on assets when the market value of the assets exceeds net book cost. Ratepayers generally bear the economic burden on most utility assets, and under the "benefit/burden" analysis, are entitled to the gain.[177]

115. Also in accordance with the case, our affiliate transactions rules do nothing to prevent ratepayers from taking a loss if assets are transferred out of regulation to a third party at less than net book value.[178] Our rules do, however, prevent ratepayers from bearing a loss when the transaction is between affiliates. In case of affiliate transactions, incentives are likely to

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[176]*See Mobile CPE Detariffing Order,* 98 FCC 2d 814, 821 (1984) (finding that the case does not compel application of a particular valuation standard).

[177]*See American Telephone and Telegraph Company,* Docket No. 19129, Phase II, 64 FCC 2d 1, 66-68 (1977) (finding that ratepayers bear the risk of loss on depreciable property and bear the financial burden on non-depreciable property while the property is in regulated service). *See also Democratic Central Committee,* 485 F. 2d at 795-800 (holding that even for nondepreciable assets. shareholders are not automatically entitled to gains in value of operating assets simply as an incident of ownership).

[178]We therefore reject AT&T's and NYNEX's suggestions that our rules are inconsistent with our prior decisions interpreting *Democratic Central Committee.* We make no attempt here to alter long standing regulatory relationships between ratepayers and shareholders and the risks that each group bears. In the case of affiliate transactions with nonregulated entities, special considerations of the potential for cost shifting require that ratepayers be protected from loss. We also reject NYNEX's argument that and *Democratic Central Committee* requires us to allocate any depreciation reserve deficiencies to regulated activities. NYNEX Petition at 20. The issue of how to deal with depreciation reserve deficiencies is being dealt with by separate Rule Making. See Amortization of Depreciation Reserve Deficiencies, Notice of Proposed Rule Making, CC Docket No. 87-47, FCC 87-313, released October 5, 1987.

exist to manipulate the transfer price. In order to maximize overall corporate profits, a carrier could sell assets to its affiliates at below net book value, leaving the ratepayer to pick up the difference.[179] The carrier simply does not have the incentive to minimize loss in a non-arm's length transaction. For this reason, this Commission fashioned the rule that transfers out of regulation to affiliates can never be recorded at less than net book cost. In this manner, ratepayers are protected from the dangers of asset value manipulation, or cost shifting.[180]

116. The limited applicability of *Democratic Central Committee* becomes even more evident in considering the case of assets transferred into regulation. In these circumstances, we believe an entirely different set of considerations apply than to assets transferred out of regulation. This Commission is not the guardian of the nonregulated entity, its consumers or its shareholders, even though it shareholders and those of the regulated entity are one and the same. Our statutory responsibility is to protect the ratepayer of a regulated utility from unjust and unreasonable rates.[181] The asset transfer rules, by requiring an asset transferred to the regulated entity to be recorded on the regulated books at the lower of fair market value or netbook cost, protect ratepayers from the potential dangers of rate base inflation that could arise if an asset is transferred at an artificially high price.[182] Thus, the balancing of ratepayer and shareholder interests which the carriers urge upon us bears no relationship to our statutory responsibilities in fashioning a rule for assets transferred into regulation.

117. We also disagree with NYNEX's argument that the residual affiliate transactions rules violate the principle that investors in public utilities are entitled to obtain a reasonable return on capital prudently invested. NYNEX uses the example of an asset transferred into regulation for which the regulated company pays its affiliate a price above net book cost. In this case, this Commission's rules would prevent inclusion in the rate base of the difference between net book cost and the price paid. The reason for this restriction is that, in light of

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[179] This was not an issue in *Democratic Central Committee*. The transit system had recorded the transfer at its full market value.

[180] We recognize that net book values depend upon depreciation rates, which in many cases are controlled by regulators. Nevertheless, we will not use this proceeding to reexamine depreciation rates.

[181] See Section 201(b) of the Communications Act of 1934, as amended, 47 U.S.C. § 201(b).

[182] We disagree with AT&T's argument that net book value of an asset held by a nonregulated entity is "meaningless." Although nonregulated depreciation is not controlled by regulators, a nonregulated entity's net book cost reflects depreciation practices that are to some extent controlled by marketplace factors. These depreciation practices must conform to generally accepted accounting principles applied on a consistent basis from year to year. They are reviewed by corporate management at the highest levels; they are audited and reported upon by independent public accountants; and they are relied upon by investors and creditors. These factors assure that the net book values of a nonregulated entity are not meaningless.

the incentives which exist to shift costs from nonregulated to regulated operations, we have no reasonable assurance that the price paid in the hypothetical transaction would approximate the market value. Therefore, rather than allowing the transaction price to establish market value, we use net book cost as a surrogate for the market price that would have been established had the transaction taken place at arm's length, between non-affiliates. The carrier can, however, avoid this result by purchasing from a third party. Although the operation of the rule may in fact discourage some affiliate transactions from occurring, we do not view such a result negatively. Improper pricing in affiliate transactions is a classic and difficult problem of rate base, rate-of-return regulation[183] and we see no reason to encourage transfer of assets among carriers and their nonregulated affiliates. If our rules have an adverse affect on potential transactions, we believe that, on balance, prevention of cost shifting is the more important goal.

118. *Expanded definition of market value.* As it is currently written, the affiliate transaction rule requires that in the first instance, transfers should occur at the "fair market value", which is defined as either the tariff price or the amount listed on a generally-available price list. If neither of these valuation mechanisms is available, the residual rule applies.[184] If we were to expand here the definition of "fair market value" beyond the tariff rate or price list to include alternative valuation mechanisms, we would greatly expand the complexity of auditing affiliate transactions. Although we have permitted a wide range of criteria of fair market value to be used under the residual rule, we expect that the residual rule will be employed only in a limited number of cases, and that most transactions will be completed using the tariff price or price list. These two valuation mechanisms, unlike the various methodologies proposed by petitioners, are readily verifiable and simple to audit. No subjective judgment need be brought to bear on the question of whether the asset was sold at its tariff or listed price.[185] In keeping with this determination, we will continue to require carriers to file waiver requests should they seek to use a valuation method that is inconsistent with our rules.

119. We also reject NYNEX's argument that net book price transfers from nonregulated affiliates to carriers include a profit component. Net book value is employed as a means of preventing the use of inflated "market" values being used to determine the transfer price.

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[183]*See* American Telephone and Telegraph Company, Docket 19129 (Phase II), 64 FCC 2d 1, 41 (1977).

[184]In taking the higher or lower of net book cost and fair market value pursuant to the residual rule, we have permitted a wide range of measures of fair market value to be used. *See Joint Cost Order*, 2 FCC Rcd at 1336 and n. 469.

[185]We also reject NYNEX's suggestion that price lists be used to determine the value of assets not generally available, so long as the price list is comparable to market prices. Such a mechanism provides an affiliate with a great deal of discretion in establishing a price and would be difficult to monitor effectively.

Adding in an unspecified profit component introduces all of the uncertainty we sought to avoid in establishing the net book or fair market value rule. Moreover, we fail to see the purpose in recording a profit as between affiliates, since the consolidated financial statements of the corporation would not reflect such profit.

120. We would like to clarify one aspect of our rule, however. By adopting the price list as an alternative methodology for determining fair market value, we intended to provide that a prevailing price could be used in lieu of a tariff price. We did not intend to require that the price be necessarily available in a "price list". So long as there are sales records from which to verify that a generally available price was charged, asset values need not be recorded in a price list format. Conversely, a price list will not be determinative if it does not represent the generally available price, or if there are not in fact a substantial number of third party transactions. Thus, an entity may not charge a list price to its affiliated carrier unless that price is in fact paid by third parties. We have amended Section 32.27 of this Commission's Rules to reflect this intent.[186]

121. *Application to specific transactions.* We will affirm our requirement that the affiliate transaction rules apply to transfers between regulated and nonregulated accounts, as well as regulated and nonregulated affiliates. This requirement is necessary to ensure that carriers do not seek to avoid our affiliate transaction rules by reincarnating a nonregulated affiliate as an operating division.[187]

122. We also clarify that the operation of the affiliate transaction rules applies only to transactions between regulated and nonregulated entities or accounts. Transactions between two regulated affiliates do not present the same potential for cost shifting and need not adhere to these rules.

B. **Valuation of Services Provided To Or By An Affiliate**

1. Background

[186]See Appendix C. We have not similarly amended the Part 31 affiliate transactions rule for the existing USOA. The current USOA will be replaced with the revised Part 32 USOA on January 1, 1988, Pursuant to 47 U.S.C. § 220(g), changes to our accounting rules do not become effective for six months. Thus, a Part 31 rule amendment made in the instant Order would not become effective until after it had been replaced with Part 32.

[187]We also reject Bell Atlantic's argument to use net book value in transfers between above the line and below the line accounts. If an asset has appreciated. the transfer of an asset at net book value to a below the line account does not permit ratepayers to benefit from the asset's appreciation, and may therefore violate *Democratic Central Committee.*

123. Services provided to or by an affiliate are subject to a slightly different set of rules than transactions involving assets. In the *Joint Cost Order,* we found that, as with asset transfers, the price of services ought to be determined by either a federally-tariffed rate or a rate on file with a state commission. If a tariffed rate does not exist, but the affiliate provides the service to third parties, the prevailing price should be used to determine the price charged to affiliates. When a carrier provides to an affiliate a service which is neither tariffed nor provided to third parties, or when a carrier receives from an affiliate a service not provided to third parties, we have required carriers to record those services at a cost determined in a manner that complies with the cost allocation standards and procedures set forth in our rules.[188]

2. Positions of the parties

124. *Valuation methodology.* A number of parties have raised issues concerning the cost allocation mechanism imposed if a tariff or generally available price does not exist-- *i. e,* on the decision to employ fully distributed costing to determine cost.[189]

125. Bell Atlantic, USTA, and U S West argue that if nonregulated entity is providing service solely to its regulated affiliate, the cost allocation standards should not be used to determine the cost of the services provided. Instead, these parties would price the services by replicating prices that unaffiliated providers are charging for the same or similar services. In addition, these parties would allow services to be provided at below the market rate, in order to benefit ratepayers.[190] Southwestern and IDCMA also assert that a nonregulated affiliate ought to be able to charge a price that is below fully allocated cost whenever the cost allocation rules are used. Southwestern argues that a price below fully allocated cost would benefit ratepayers, and would keep the nonregulated service provider competitive with third

[188]Sections 31.01-ll(d) and 32.27(d) of the Commission's Rules, *printed in* 2 FCC Rcd at 1342, 1345, *to be codified at* 47 C.F.R. §§ 31.01-ll(d) and 32.27(d).

[189]In conjunction with the rule on services, Cincinnati Bell has also raised an accounting issue. Cincinnati Bell argues that in the case *of* services provided by the carrier to an affiliate, which are not tariffed or otherwise offered to third parties, carriers should be allowed to reduce expenses rather than record a revenue. Cincinnati Bell states that if the amounts to be received from the affiliates for such services are recorded as revenues, they would be subject to a gross receipts tax. Cincinnati Bell Petition at 12-14. The application of a state gross receipts tax is an issue involving Cincinnati Bell and the Ohio taxing authority. We therefore do not elect to alter our accounting procedures in the manner suggested by Cincinnati Bell.

[190]Bell Atlantic Petition at 6-7; Bell Atlantic Reply at 4, n. 3; USTA Petition at 6; and U S West Petition at 13-19.

party providers.[191] Furthermore, Bell Atlantic and U S West argue that use of cost allocation standards will discourage intracorporate provision of service, and that there is no assurance that the cost of a service as determined under the standards will be sufficient from the nonregulated entity's point of view.[192] U S West states that so long as the carrier is free to purchase services from non-affiliates, the marketplace will control abusive practices.[193] USTA also argues that mandating that the provision of service be provided pursuant to fully allocated cost constitutes unauthorized regulation of nonregulated affiliates.[194]

126. Two parties also advocate that the cost allocation process for determining the cost of services provided solely to an affiliate include a measure of profit, so as to make the cost allocation process more comparable to an arm's length transaction. U S West proposes that services obtained by a carrier from its nonregulated affiliate should be allowed to generate a profit commensurate with those earned by third party service providers.[195] Ad Hoc, adopting a more limited view, argues that only regulated entities ought to be able to earn a profit on untariffed services provided to their nonregulated affiliates.[196]

127. Various parties oppose the proposals to modify the fully allocated costing rule. Ad Hoc opposes modifications that would permit prices for services to be set by reference to the marketplace.[197] CompuServe alleges that by adopting the changes proposed, carriers would have an incentive to form subsidiaries to provide services that would otherwise be provided

[191]Southwestern Petition at 16-19 and IDCMA Opposition at 7-8.

[192]Bell Atlantic Petition at 7-8 and U S West Petition at 13-18;.

[193]U S West Petition at 18-19

[194]USTA Petition at 6-7.

[195]U S West Petition at 13-18.

[196]Ad Hoc Petition at 18-21 and Ad Hoc Reply at 9. Ad Hoc also suggests that the timing of the provision of service should prevent carriers from earning a profit. Ad Hoc uses the example of an employee transferred from the carrier to its nonregulated affiliate, and asserts that the affiliate ought to compensate the carrier for that employee's training costs. Ad Hoc Petition at 18-21 and Reply at 10. Several parties attack this proposal as inconsistent with normal business practice and as an attempt to allocate the cost of an intangible benefit. Ameritech Opposition 8-9; Bell Atlantic Opposition at 8-9; and USTA Opposition at 9.

[197]Ad Hoc Opposition at 23, n. 8

in-house, simply to avoid fully allocated costing.[198] IDCMA also opposes suggestions to price services by reference to what nonaffiliated providers are charging for similar services. IDCMA argues that providing price flexibility in the manner suggested by the industry will create auditing problems.[199]

128. Oppositions have also been filed to the proposals to include profit in the allocated cost of the service provided by a carrier to a nonregulated affiliate. Ameritech contends that under the operation of the cost allocation standards, a portion of the "profit" of services provided to a nonregulated affiliate are already allocated to the nonregulated entity because, as costs are allocated to nonregulated activities, the carrier's rate base shrinks. Bell Atlantic argues that fully allocated cost includes a return on investment, and therefore the carrier is adequately compensated.[200]

129. *Support services organizations.* BellSouth argues that its support services organizations, which are wholly owned by the carriers and exist solely for the benefit of the operating telephone companies, should be exempt from the affiliate transaction rules. According to BellSouth, its support services organization serves a procurement function for its operating companies, and therefore generates efficiencies which separate procurement operations could not realize. In addition, BellSouth alleges that all of the profits of the support services organization are returned to the operating companies to reduce their revenue requirement.[201]

3. Discussion

130. *Valuation methodology.* We decline to change the rule we have adopted for valuation of services which a carrier provides to or receives from an affiliate because we view that requirement as essential to the integrity of our cost allocation rules. If we were to allow a carrier to perform services for a nonregulated affiliate on a less than fully distributed cost basis, we would create an incentive for the carrier to proliferate "paper" affiliates solely to avoid our cost allocation standards. For example, enhanced services would more than likely

[198]CompuServe Opposition at 9-10.

[199]IDCMA Opposition at 8.

[200]Ameritech Opposition at 8; and Bell Atlantic Opposition 7-8; *See also* BellSouth Opposition at 9 and USTA Opposition 7-9.

[201]BellSouth Petition at 23-24. See *also* U S West Opposition 5-6 (supporting BellSouth's proposal) and U S West Petition 15-17 (arguing that unless procurement' entitles are permitted to earn a profit, they will have little incentive to serve telephone operating companies).

be offered through affiliated entities, regardless of whether the provision of service by affiliates was the most efficient method of offering service. Such an arrangement would provide none of the regulatory benefits of structural separation, since the carrier and its affiliates would be free to decide how much of the shared costs would be allocated to the carrier. The use of separate entities would both allow the carrier to evade our determination that the benefits of combined operations should be shared by ratepayers and shareholders, and greatly complicate the auditing process. Similarly, if we were to allow a holding company or its affiliate to provide services to both carrier and noncarrier affiliates without fully allocating the costs of those services, we would create the incentive for carriers to escape the cost allocation rules by moving their service departments into nonregulated affiliates. Cost allocation rules which could be so easily circumvented would provide little protection against cost shifting and would be a poor substitute for mandatory structural separation.[202]

131. Several parties have argued that if a tariff or prevailing price is unavailable as a measure of value, we should look to the value of similar services in the marketplace. We believe that such a valuation standard is fraught with the potential for abuse and would be difficult to monitor. In contrast, by requiring carriers and their affiliates to allocate costs pursuant to the cost allocation standards, we can ensure that an auditable measure of the cost of the service is available. The suggestion that the marketplace will regulate abusive practices, so long as carriers are free to contract with unaffiliated service providers, is unpersuasive. First, it is not clear that we should ever assume that carriers are free to deal at arm's length with their parent corporations, commonly-controlled affiliates, or subsidiaries. Second, if an exclusive service arrangement has existed, the transaction costs of initiating a new service arrangement, with a corporation that is not under common control with the carrier, are likely to interfere with the carrier's ability to take its business elsewhere. Thus, the potential for abuse remains.

132. In addition, we disagree with arguments that our valuation rules constitute an unauthorized regulation of nonregulated affiliates. We are not, through the operation of these or other rules, attempting to regulate the price at which a nonregulated affiliate must sell its services. Our interest in this area extends solely to the protection of ratepayers, and specifically to the value at which service obtained or provided by a carrier is recorded on the regulated books of account. Only in the case of transactions for services involving an affiliate that does not also serve the public do we require the affiliate to use a specific valuation methodology--the cost allocation standards found in Section 64.901. This requirement is necessary because, if an exclusive relationship exists between a carrier and its affiliate, our rules must reflect that the service being provided or obtained is a shared service. If the affiliate wishes to charge a price for its services higher than the rules permit, it is free to seek

[202] 2 FCC Rcd at 1336-37.

out customers elsewhere. Our rules have been promulgated under Section 201 of the Act to prevent ratepayers from being charged unreasonable rates. We therefore believe that our rules, to the limited extent they affect nonregulated affiliates, are within our jurisdictional authority.

133. Parties have stated forcefully the belief that a profit component should be included in the allocation process but have offered no persuasive reason why such profits ought to be permitted. If the provision of services between a carrier and its affiliate is an exclusive relationship, we perceive no need to give recognition to corporate boundary line for the purpose of earning a profit.[203] Furthermore, the cost allocation standards already permit a return on investment to be included in the cost to be apportioned. Finally, carriers or affiliates interested in earning profits on the sales of services always have the option of third party transactions.[204]

134. *Support services organizations.* We are not persuaded by BellSouth's argument that support services organizations, which are wholly owned by the carriers and exist solely for the benefit of the operating telephone companies, should be exempt from the affiliate transaction rules. The rules do not prohibit these organizations and thus do not deny the

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[203]There is, of course, no actual profit to be realized by overall enterprise in a transaction between affiliates But when a nonregulated affiliate is used to provide a service to a regulated entity, a profit markup (above cost plus return on investment' can be used to shift costs to ratepayers. For example, if a payroll department is located within an operating company, the company will include in its rates all of the costs associated with the department, including a return on investment. If we were to grant the petitions of carriers seeking an allowance for "profit," that same payroll function, transferred to an affiliated entity, could assess the operating company a fee which included all of its cost, return on investment, *and* an additional amount. Unless explicitly "disallowed in a rate case, the entire fee would be included in rates for regulated service. Since the nonregulated entity would not be subject to rate-of-return constraints on its profits, the effect would be that ratepayers would pay more, and the additional amount they paid would flow to the nonregulated side of the company business. *See* Garfield and Lovejoy, Public Utility Economics 439 discussion of abusive potential of service company fees). While we realize that transfer pricing schemes which include intracompany profits can be used to provide incentives to, and measure the performance of, managers of service companies, we believe that the risks of cost shifting justify the rule we have adopted, and companies can find other ways to motivate and assess service affiliate managers. For these reasons, we also reject U S West's argument that procurement entities must be permitted to earn a profit.

[204]We disagree with Ad Hoc's suggestion to charge nonregulated entities for employee training of employees that have transferred from the carrier to the nonregulated affiliate. We are persuaded by the arguments of others that employee training is a sunk cost that is not routinely reimbursed when the employee is transferred, and that the value of previous training is an intangible benefit, the allocation of which is beyond the scope of this proceeding. If, however, we obtain information through our oversight of carriers substantiating that a regulated entity is providing employee training as a service to its nonregulated affiliates without following our affiliate transactions rules for the provision of service, we will require the carrier to adhere to those rules and take such other action as required.

companies the efficiencies that BellSouth alleges that these organizations generate.

135. Furthermore, we disagree that ratepayers are not adversely affected so long as profits are returned to the operating companies. The costs recorded by telephone companies must be allocated for jurisdictional separations and for individual services before they are used to determine revenue requirements. There is no assurance that the profits returned as revenues to the companies would be allocated in the same manner as the costs they are intended to offset. Moreover, shifts between accounting periods could result if, for example, costs billed to a telephone company were capitalized while the profits returned were recognized as revenue in the current period. For these reasons, we are not exempting support services organizations from the affiliate transaction rules as recommended by BellSouth.

C. **Disclosure of Information Concerning Transactions**

1. Background

136. In the *Order* we decided not to require carriers to reduce affiliate transactions to writing and make them publicly available. We indicated that we would review transactions as part of the audit process, and that we expected carriers to retain sufficient documentation to enable us to assess affiliate transfers.[205]

2. **Positions of the parties**

137. Ad Hoc argues that this Commission should clarify its statement concerning the retention of documentation to require that all transactions be reduced to writing and that valuation mechanisms be specified. While contemporaneous public disclosure need not be required, Ad Hoc suggests that transactions should not be completely exempted from public disclosure requirements.[206] Ad Hoc also says the cost manuals should include a general description of affiliate transactions, as well as a description of valuation standards. NYNEX and USTA object to Ad Hoc's proposal. Both parties oppose suggestions to require more information in the cost manuals, and USTA opposes proposals to retain additional information on transfers.[207]

3. Discussion

[205] 2 FCC Rcd at 1336-37.

[206] Ad Hoc Petition at 21-23.

[207] NYNEX Opposition at 4, n. 7 and USTA Opposition at 9-10.

138. As adopted, the *Joint Cost Order* requires carriers to retain sufficient documentation to enable us to assess whether affiliate transactions were conducted in compliance with our rules.[208] In their cost manuals, carriers are expected to include a chart showing all of their corporate affiliates, as well as "[a] statement identifying affiliates that engage in transactions with the carrier entity and describing the nature, terms, and frequency of such transactions."[209] Given these two complementary requirements, we do not at present perceive a need to establish further obligations on carriers, such as reducing individual transactions to writing. Furthermore, we will not establish a rule that the documentation retained in conjunction with transactions could be made public at some future date. To the extent we are in possession of such documentation, and are retaining it in our files, our Freedom of Information Act rules will apply to the release of such information.

V. GENERAL ISSUES

139. A number of parties have raised issues concerning the scope of this proceeding In addition to setting forth alternative goals and purposes to be attained through the operation of joint and common cost rules, the parties have raised questions concerning the applicability of the *Order* to small telephone companies, to connecting carriers, and to specific activities.

A. **Goals and Purposes**

1. Background

140. In the *Order*, we found that the primary purpose of this proceeding is to protect ratepayers from unjust and unreasonable interstate rates by providing an accounting system which identifies the costs required to provide regulated services. We also found that this proceeding furthers the goal of maximizing the availability to the public of efficient, low-cost telecommunications services of all kinds by enabling carriers to offer enhanced services and CPE on an unseparated basis. Although we were concerned with reducing the potential for unlawful cross subsidies between regulated and nonregulated activities, we recognized an additional goal of ensuring that ratepayers share in any efficiencies to be generated from the joint use of the network. We declined, however, to design an accounting system for the purpose of providing information on the pricing of nonregulated services and products. We found such information to be unnecessary to the exercise of our statutory responsibilities.[210]

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[208] 2 FCC Rcd at 1337.

[209] 2 FCC Rcd at 1328.

[210] *Joint Cost Order*, FCC Rcd at 1303-04.

2. Positions of the parties

141. Two parties would have us amend our stated purposes to include additional goals.[211] Ad Hoc urges us to adopt what it calls a "marketplace" approach, which would require this Commission to interpret our rules in a manner that places a carrier's nonregulated activity on the same footing as a nonaffiliated, start-up venture. Ad Hoc argues that the majority of any efficiency savings generated by joint use of the network ought to be assigned to ratepayers, because new ventures are rarely profitable. Initially. Similarly, IDCMA argues that the goals of the proceeding ought to include protection of competitive markets.

3. **Discussion**

142. As we stated in the *Joint Cost Order*, our primary statutory mandate is to protect ratepayers from unjust and unreasonable rates. Our concern first and foremost is with regulated costs and revenues, and specifically, with ensuring that the costs of nonregulated activities are separated from regulated costs. We have in proceedings such as Computer III[212] and Computer II[213] acted to prevent anticompetitive behavior that would adversely affect ratepayers. We have declined, however, to base our regulatory activities solely on the basis of protecting individual competitors in the marketplace. Our efforts, as demonstrated in the *Computer III* proceeding as well as here, are directed toward providing equal opportunities for entrants to compete, as well as endeavoring to ensure that a carrier's ratepayers do not shoulder the investment risk of nonregulated activities.

B. Applicability to Small Telephone Companies

1. Background

143. The *Order* adopted in this proceeding applies the joint and common cost standards and the affiliate transaction rules to all local exchange and dominant interexchange carriers. We found that these carriers, large and small, have both the opportunity and incentive to cross subsidize nonregulated operations. In fact, companies that have not been subject to our structural separations provisions have long had the opportunity to integrate regulated and

[211] Ad Hoc Opposition at 2-8 and lDCMA Petition at 1-4.

[212] Amendment of Sections 64.702 of the Commission's Rules and Regulations *(Third Computer* Inquiry), Report and Order, 104 FCC 2d 958 (1986) *(Phase I Order), modified on recon.* 2 FCC Rcd 3035 (1987) and *Phase II Order,* 2 FCC Rcd 3072 (1987).

[213] *See* note 5 *supra*.

nonregulated activities.[214] We determined that all ratepayers, whether served by large or small companies, were entitled to the protections our rules were intended to afford.[215]

144. We rejected arguments concerning the burden and expense of complying with our rules. We reasoned that all telephone companies offering nonregulated services or products must apportion costs between their regulated and nonregulated offerings in order to support their various tariff filings, as well as for internal purposes. Our cost allocation rules at most represented a requirement that carriers modify their existing cost accounting systems. Compliance with our rules was therefore mandated for all local exchange companies and AT&T.[216]

145. While all exchange carriers are required to comply with our accounting procedures, we exempted all but the Tier I carriers from certain specific enforcement provisions, including the provision that carriers submit their cost allocation manuals to this Commission for review and approval. We also exempted smaller carriers from the requirement that they commission an annual audit from an independent auditing firm to verify that they are adhering to the accounting procedures established in their manuals.[217]

2. **Positions of the parties**

146. *Applicability to average schedule or other small carriers*. Several parties argue that the accounting rules established in the *Order* ought not to apply to small carriers or to average schedule companies.[218] NTCA challenges our finding that compliance with the cost

[214]Structural separation of nonregulated communications activities was required of the BOCs in the *Second Computer Inquiry. See* Section II, *supra.* This Commission has since decided to pursue a regulatory policy that permits integration of services. *Id.* Of course, the BOCs remain subject to the Modified Final Judgment's line of business restrictions, which limits their ability to offer "information" services, limitation that includes many enhanced services. *U. S.* v. *Western Electric Co.,* Civil Action No. 82-0192 (D.D.C. September 10, 1987).

[215]*Joint Cost Order,* FCC Rcd at 1304-06.

[216]*ID* at 1304-05.

[217]*Id.* at 1304.

[218]Average schedule companies do not attempt to determine their own costs for the purpose of setting interstate rates, but instead receive compensation that simulates the interstate cost study settlements that would be received pursuant to Section 69.607 by a company that is representative of average schedule companies. *See* 47 C.F.R. §69.606(a). Use of an average schedule eliminates the necessity of conducting expensive and burdensome cost studies. *See MTS and WATS Market Structure: Average Schedule Companies,* 103 FCC 2d 1017, 1018-19 (1986), *remanded on other grounds in City of Brookings Municipal Telephone Co. v. FCC,* 822 F.2d 1153

allocation rules would not be burdensome for small carriers. While NTCA acknowledges that separate accounting for regulated and nonregulated activities ought to be required, it argues that the particular set of rules adopted by this Commission constitutes an entry barrier that will impede the development of nonregulated services in the areas served by small carriers.[219] OPASTCO argues that the magnitude of costs associated with the small carriers' provision of nonregulated activities does not warrant the imposition of additional regulatory burdens.[220] USTA argues that the joint cost rules, which are part of the effort to replace structural separations, should not apply to companies that were exempt from *Computer II.*[221]

147. Both NTCA and USTA argue that the Commission should exempt average schedule companies from the accounting provisions of the *Order.* Determining the actual regulated costs of average schedule companies is an unnecessary exercise so long as their interstate access rate are based on an average schedule of costs, according to these parties.[222]

148. AT&T opposes modifications to the joint and common cost rules that would exempt small carriers or average schedule companies. AT&T says that this Commission has already taken small carriers needs into account by exempting them from filing cost manuals and undergoing an annual audit.[223]

149. *Exemption of all non - BOCs.* Two carriers argue that those entities not subject to the *Compuler II* structural separations[224] ought not to be subject to the joint and common cost manual filing and auditing requirements Cincinnati Bell asserts that it should be subject only to the accounting requirements of the *Order.* Cincinnati Bell presents four arguments to support its proposal: (1) at a time when this Commission is attempting to introduce more

(D.C.Cir. 1987).

[219]NTCA Petition at 6-7 and NTCA Reply at 5. *See also* USTA Petition at 22-26. Commerce, while not advocating a specific change, urges us to review carefully the requirements for small carriers. Commerce states that removal of regulatory burdens for small carriers would be consistent with this Commission's own regulatory policies and representations that this Commission has made to Congress. Commerce Opposition at 2.

[220]OPASTCO Opposition at 2-3.

[221]USTA Petition at 22-23 and Opposition at 14-15. USTA also argues that this Commission has failed to meet its Regulatory Flexibility Act requirement with regard to small companies. USTA Petition at 26, n. 40.

[222]NTCA Petition at 6-7; NTCA Reply at 5; and USTA Petition at 22-26.

[223]AT&T Opposition at 5,n.**.

[224]See Section II, *supra.*

flexibility and less regulation for the BOCs, additional regulations on independent exchange carriers should not be imposed; (2) Cincinnati Bell's accounting for regulated and nonregulated costs is subject to extensive state regulatory scrutiny; (3) as a relatively small Tier 1 carrier, it can no more afford to file a cost manual and conduct annual audits than the largest Tier 2 companies; and (4) because this Commission is applying the *Computer III* requirements only to the BOCs and AT&T, the auditing and filing requirements ought to apply only to those carriers.[225] Rochester supports Cincinnati Bell's position. Like Cincinnati Bell, Rochester argues that its state commission is active in overseeing accounting for regulated and nonregulated activities.[226]

150. The Ohio Consumers' Counsel opposes Cincinnati Bell's arguments for exemption from the filing and auditing requirements. The Ohio Consumers' Counsel argues that accounting separation of regulated and nonregulated costs has traditionally been an area of strong concern state regulators, and that Cincinnati Bell's aggressive diversification program warrants the imposition of cost manual and auditing requirements.[227]

151. *Application to Connecting carriers.* Several parties argue that connecting carriers, those which provide interstate communications solely through their connection with other carriers, are statutorily exempt from the rule adopted in this proceeding. Section 2(b) of the Communications Act of 1934, as amended, states that carriers providing interstate communications "solely through physical connection with the facilities of another carrier" are exempt from all but Sections 201-205, 224, and 301 of the Act.[228] NTCA, OPASTCO and PSTC argue that the connecting carriers are therefore exempt from all accounting rules adopted pursuant to Section 220(a) of the Act, including the rules adopted in this proceeding. They note that connecting carriers have been exempt from the USOA. These parties argue that under *Louisiana Public Service Commission v. FCC,*[229] which construed Section 2(b)(1) of the Act to limit the Commission's authority to prescribe preemptive depreciation rates under Section 220, connecting carriers cannot be made subject to accounting rules for joint

[225] Cincinnati Bell Petition at 2-10.

[226] Rochester Reply at 1-6.

[227] Ohio Consumers' Counsel Opposition at 2-4.

[228] 47 U.S.C.§152(b).

[229] 106 S. Ct. 1890 (1986).

and common costs.[230] In addition, PSTC argues that Section 201's requirement for just and reasonable rates cannot be used to justify the imposition of accounting rules in the face of the explicit, limiting language of Section 2(b)(2).[231]

152. AT&T argues that this Commission does have the authority to impose joint and common cost accounting rules on connecting carriers. According to AT&T, Section 2(b)(2) does not limit our ratemaking authority, which necessarily includes the authority to determine revenue requirements. Thus, under Sections 201 and 205, this Commission can apply its joint and common cost rules to 2(b)(2) carriers. AT&T also argues that *Louisiana* must be read as a preemption case, which sharply limits its applicability here.[232]

153. In response NTCA and PSTC argue that AT&T's argument that the joint and common cost rules can be justified under Sections 201-205, is erroneous. According to these parties, the plain language of Section 2(b)(2) demonstrates that AT&T's argument is unsupportable. PSTC also argues that *Louisiana* has been broadly construed as applicable to a number of situations, and should not be read as narrowly as AT&T suggests.[233]

3. **Discussion**

154. Applicability to average schedule or other small carriers. As we have previously explained, the purpose of this proceeding is to ensure that the costs of nonregulated activities are separated from the costs of providing regulated services in a manner which ensures that ratepayers share in the efficiencies generated from joint use of the network. By removing nonregulated costs from regulated costs, we will fulfill our statutory obligations to protect ratepayers from unjust and unreasonable rates.[234] The first step in calculating the interstate

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[230] NTCA Petition at 2-5; NTCA Reply at 3-5; OPASTCO Opposition at 2-10; and PSTC Petition at 3-9. *See also USTA* Petition at 22-26.

[231] PSTC Petition at 3-9.

[232] AT&T Opposition at 5, n **

[233] NTCA Reply at 2-3 and PSTC Reply at 1-4. *See also USTA* Reply at 8-9.

[234] We have relied on several sections of the Communications Act as the basis for our authority to enact these rules. Section 201(b) requires us to evaluate rates to ensure that they are just and reasonable. Section 218 authorizes us to inquire into the management of all carriers and their affiliates. Section 219 provides us with the authority to require carriers to file reports, and Section 220(a) authorizes us to prescribe accounts, records, and memoranda to be kept by carriers. In addition, Section 4(i) authorizes us to " . . . perform any and all acts, make such rules and regulafions, and issue such orders, not inconsistent with this Act, as may be necessary in the

revenue requirement is the separation of regulated from nonregulated costs. Regulated costs then are subject to the jurisdictional separations process, which determines the amount of investment and expense to be recovered by carriers in their interstate and intrastate rates.[235] The amount of investment and expense to be recovered from the interstate jurisdiction is then used to determine a carrier's interstate revenue requirement. The joint and common cost standards established in this proceeding are therefore an essential step in the process of reviewing carrier revenue requirements and, subsequently, rates.

l55. In the case of the average schedule companies, however, no attempt is made to measure the actual costs of providing regulated services. These companies receive compensation that is approved by this Commission that simulates the compensation that would be received by a cost company that is representative of average schedule companies in lieu of a determination of actual costs. This avoids imposing burdens of developing cost information on companies that may be too small to warrant such a burden. Ratepayers are safeguarded from the potential burden of paying for nonregulated activities because our average schedule approval process automatically excludes the costs and expenses of nonregulated activities.[236] We expect that all companies use some type of procedure to separate their regulated and nonregulated costs. However, requiring average schedule carriers to separate their nonregulated from their regulated costs according to a set of procedures prescribed by this Commission would be a meaningless exercise, and would create an unnecessary regulatory burden. An analysis of actual costs, even if required, would have no resulting impact on interstate rates. We therefore agree with the comments filed by NTCA and USTA that for carriers whose rates for regulated services are based on average schedules, there is no need to adhere to the cost allocation procedures established in our Order.

Accordingly, we take this opportunity to clarify that average schedule companies are exempt

execution of [our] functions." Based on this authority, we have devised a regulatory mechanism that requires the division of nonregulated and regulated costs for the purpose of ascertaining that rates paid for regulated services are just and reasonable. We are not attempting to exercise any regulatory authority over nonregulated costs and activities beyond assuring that the division of regulated and nonregulated costs meets our statutory goal of protecting ratepayers.

[235] States are, of course, free to establish their own division of regulated and nonregulated costs. See Joint Cost Order, 2 FCC 2d at 1310. The intrastate revenue requirement established through the application of jurisdictional separations may not necessarily be the revenue requirement that will form the basis for intrastate rates.

[236] *See* note 218, *supra* and 47 C.F.R. §69.606(a).

from the requirements set forth in this proceeding.[237]

156. The reasons which support an exemption of average schedule companies from the rules established in this proceeding do not support an exemption for all non-Tier 1 cost companies. Carriers which establish their actual costs, through cost studies or other methods, by necessity must segregate the costs of their nonregulated activities from their regulated activities in order to reflect accurately those regulated costs in their rates. Moreover, companies other than BOCs have been required to maintain accounting separation between regulated activities and CPE or enhanced services since 1980, when they were relieved of structural separation requirements imposed on them under *Computer I.* The use of fully distributed costing to separate regulated and nonregulated costs has been required Since 1984.[238] Given that the cost allocation process is one which all cost companies must undertake, and one which we have mandated for several years, we fail to see why our requirement that all cost companies follow our procedures is unduly burdensome. The basic cost allocation standards we have established are unremarkable in that they rely on the attributable cost method of cost allocation, a common method of segregating the costs of activities.[239] This method is relatively straightforward to apply. Direct assignment, direct attribution, indirect attribution and use of a general allocator represent a common-sense hierarchy of allocation principles that can be routinely followed in separating costs of regulated and nonregulated activities.

157. While we are sympathetic to the concerns of the smaller cost companies, we believe that compliance with our rules will not be as difficult or as burdensome as some would suggest. An examination of most carriers' current cost allocation procedures would likely find that most existing methods of allocating costs are in compliance with our *Order.* Smaller cost companies should not feel compelled to abandon their current allocation methods and start from scratch. Instead, they should build on mechanisms already in place, reviewing their existing methodology for compliance with the *Order.* The resources they devote to this effort should be in keeping with present and projected levels of nonregulated costs. In this process, they should be substantially aided by the prototype cost manual developed by the

[237]Average schedule companies are, therefore, exempted from the affiliate transaction rules, as well, because the affiliate transaction rules are intended primarily to prevent carriers from circumventing our fully allocated cost standards.

[238]*See* note 9, *supra*.

[239]This method's reliance on cause and effect relationships is widely established. *See generally* 4 C.F.R. Part 418; Letricia Gayle Rayburn, *Principles of Cost Accounting: Managerial Applications* (1986) at Chapter 6; and Charles T. Horngren, *Cost Accounting, A .Managerial Emphasis* (1982) at Chapter 14.

United States Telephone Association.[240] Smaller cost companies should not find themselves overtaxed by this process. We therefore decline to exempt all non-Tier 1 cost companies from the requirements of our *Order*.[241]

158. *Exemption of all non - BOCs. As* we previously mentioned, the independent local exchange carriers have been required to allocate costs between regulated and nonregulated businesses on a fully-distributed basis since the adoption in 1984 of the Fifth Report and Order in the *Computer 11 Implementation Proceeding.*[242] At that time, we stated we would undertake in a future proceeding a resolution of sptecific cost allocation rules for the independents. Since then, our decisions to abandon the structural separation approach of *Computer II* for AT&T and the BOCs have meant that our cost allocation Rule Making efforts are now directed at a broader class of carriers. The instant proceeding would have been necessary, however, even if we had retained the *Computer II* scheme in its entirety. Arguments that non-BOCs should be exempt from our rules because they were not subject to *Computer* II are, therefore, misconceived.

159. We also find that state regulatory oversight of cost allocation mechanisms is insufficient to satisfy our statutory purposes in assuring that interstate rates are just and reasonable. Even if some state regulatory agencies play an active role in preventing the commingling of regulated and nonregulated costs, they are under no duty to adhere to the methodology we have created or to insure in any way that nonregulated costs do not enter *interstate* revenue requirements. Moreover, oversight efforts are likely to be inconsistent from state to state as determined by resources, regulatory philosophy and other factors.

160. *Application to connecting carriers.* Carriers that provide interstate communications solely through their connections with other carriers are not subject to the full panopoly of Title 1I regulation. Pursuant to Section 2(b)(2), this Commission may exercise its jurisdiction over connecting carriers pursuant to its authority under Sections 201-205, 224, 301 and Title

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[240]The prototype manual was developed as an industry model by the United States Telephone Association (USTA).

[241]We also disagree with USTA's argument that we have failed to satisfy the Regulatory Flexibility Act requirements in this proceeding *See Joint Cost NPRM,* 104 FCC 2d 59, 109 (1986). With respect to the modifications to the rules and requirements made in this order, we certify that the Regulatory Flexibility Act is not applicable, although we have elected to conduct an analysis of the effect of these modifications on small companies. *See infra* para. 209.

[242]*See* note *9, supra.*

Vl.[243] We have recognized that the Section 2(b)(2) limits to our jurisdictional authority were intended to exempt small independent carriers from certain aspects of the Commission's jurisdiction. The legislative history of Section 2(b)(2) illustrates a Congressional intent to protect small, locally-owned telephone companies from the full measure of federal regulation that might otherwise apply simply because their local network is connected with a toll line for long distance calls.[244] Among the sections of the Act not applicable to connecting carriers is Section 220, which provides authority for this Commission to prescribe accounts and depreciation rates.[245] After reviewing the arguments of the parties, which focus on the omission of Section 220 from the list of statutory provisions that apply to 2(b)(2) carriers, we nevertheless affirm our decision to apply the *Joint Cost Order* to connecting carriers.

161. We have discussed above the significance of our cost allocation procedures to the eventual determination of the interstate regulated revenue requirement, and thus, to the determination of whether a carrier's rates are just and reasonable. Therefore, even in the absence of Section 220, we have authority to promulgate these rules for all carriers under Section 201, which mandates that all rates shall be just and reasonable, and Section 205, which authorizes this Commission to prescribe just and reasonable charges.[246] We find it necessary to require allocation of costs between regulated and nonregulated activities and the application of the affiliate transaction rules for all carriers, including connecting carriers, to meet our Section 201 and 205 responsibilities to assure that all carriers' rates are just and reasonable. Thus, the application of industry-wide cost allocation standards to all carriers does

[243] Section 2(b) provides, in pertinent part:

Except as provided in section 224 and subject to the provisions of Section 301 and Title Vl, nothing in this Act shall be construed to apply or give the Commission jurisdiction with respect to. . .(2) any carrier engaged in interstate or foreign communication sorely through physical connection with the facilities of another carrier not directly or indirectly controlling or controlled by, or under direct or indirect common control with such carrier . . . except that Sections 201 through 205 of this Act. . . shall. . . apply. .

[244]Declaratory Ruling on the Application of Section 2(b)(2) of the CommunicationsAct of 1934 to Bell Operating Companies, 2 FCC Rcd 1750 citing 78 Cong. Rec. 8846 (Remarks of Senator Clark)(1934) and Hearings on H.R. 8301 Before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. at 241 (testimony of Mr. F.B. Mackinnon) (1934).

[245] 47 U.S.C. §220.

[246]Section 4(i) empowers us to make such rules and regulations as may be necessary in the execution of our functions. *See New England Telephone and Telegraph Co. v. FCC*, No. 85-1087, Slip Op. (August 21, 1987) at 14-15, citing *North American Telecommunications Association v. FCC, 772* F.2d 1282, 1292 (7th Cir. 1985).

not exceed our jurisdiction and is consistent with out statutory mandate.[247]

162. In reaching this determination, we have reviewed a near-identical challenge to our jurisdictional authority raised in the wake of our *Computer I* decision,[248] which represented an early effort of this Commission to avoid regulation of non-telecommunications computer services In the subsequent appeal of *Computer I*, the Court of Appeals affirmed this Commission's assertion of our Section 201 and 205 authority over connecting carriers in applying the rules requiring maximum separation of communications and computer services.[249] The Court found that connecting carriers, because they are part of an un interrupted and indivisible national system of telephone service, were properly included in the application of the *Computer I* rules pursuant to this Commission's authority over rates.[250] The cost allocation rules at issue here are in part. descendants of the *Computer I* rules in that they represent a piece of a regulatory regime which permit carriers to offer both communications services as well as enhanced services.

163. We find the arguments raised by some parties, that our actions are prohibited by the *Louisiana* decision, to be unpersuasive, *Louisiana* found that the limitation on federal jurisdiction contained in Section 2(b)(1) prevented this Commission from using our authority under Section 220 of the Act to prescribe depreciation rates for use in intrastate ratemaking.[251] Section (2)(b)(1) is the provision of the Act which denies this Commission jurisdiction overcharges, classifications, practices, services, facilities, or regulations for the intrastate services of any carrier. *Louisiana* is inapposite to the case at hand for two reasons. First, *Louisiana* does not address section 2(b)(2) at all, and thus does not limit the range of regulatory tools we may employ in exercising our Section 201-205 powers over the interstate services of connecting carriers. Second, the cost allocation rules at issue here do not preempt

[247]In the *Joint Cost Order*, we elected to codify the affiliate transaction rules in the existing USOA, Part 31, and in the revised USOA, Part 32. In this *Order*, we are amending our rules to add the affiliate transaction requirements to Part 64 to make clear that these requirements apply to all fully subject carriers. *See* Appendix B. We take this action pursuant to our statutory authority under Sections 201 and 205 of the Act, as well as the other statutory sections cited at note 234, supra.

[248]34 FCC 2d 557, 569 (1972).

[249]*GTE Service Corporation v. FCC*, 474 F.2d 724, 736 (1973). *See also Com Services, Inc. v. Murraysvide Telephone Co.*, 57 R.R.2d 929 (1985) (finding that Sections 206 and 207 concerning damages liability apply to connecting carriers by virtue of the application of Sections 201-205).

[250] 474 F .2d at 736.

[251]106 S.Ct. at 1904.

state regulation.[252] To the contrary, we have specifically found the states are not bound by the revenue requirement obtained from the application of our cost allocation system. We therefore believe that the *Louisiana* decision does not bar the application of our rules to connecting carriers.

C. **Applicability to Specific Types of Activities**

1. Background

164. The accounting rules adopted in the *Implementation Proceeding* (Fifth Report and Order) accorded non regulated accounting treatment to all telephone company activities which were neither subject to federal tariff regulation nor actually offered under state tariff.[253] In the *Joint Cost Order* we decided that this definition of "nonregulated" activity was too broad for our purpose, separating regulated from nonregulated costs.[254] We decided, instead, to classify as regulated activities for accounting purposes, all those activities classified as common carrier communications for purposes of Title II of the Communications Act. That is, all common carrier communications services, whether tariffed or not, would be accounted for as regulated activities. All activities which were never subject to Title II regulation as common carrier communications, and all activities preemptively r moved from common carrier regulation, would be accounted for as nonregulated activities. However, we did not specify the treatment to be accorded to all activities which we might remove from common carrier regulation in the interstate jurisdiction only. We decided that, because of possible impacts on the jurisdictional separations process, we would determine the accounting classification for each such service at the time of deregulation. We further decided that billing and collection for other carrier services, which we had removed from regulation as a common carrier service at the federal level only, should be treated as a regulated service for cost allocation purposes, and continue to be subject to jurisdictional separations. The interstate billing and collection costs identified through that process will, however, be removed from the Part 69 access elements and the interexchange category.[255]

[252] *See* 2 FCC Rcd at 1310.

[253] *See supra* note 9.

[254] As we have previously stated, *supra* note 235, we are not preempting state ratemaking authority over the division of regulated and nonregulated costs for intrastate ratemaking purposes. *See Joint Cost Order* at 1310. The discussion concerning the applicability of the joint cost rules to specific activities, therefore, concerns the development of an interstate revenue requirement only.

[255] *Joint Cost Order* at 1307-09.

165. In addition, we decided that some nonregulated activities. which had traditionally been accounted for within regulated accounts because they were considered mere outgrowths of regulated operations. were too insignificant to require that the cost allocation rules be applied to them. We called these activities "incidental." In the *Order*, we allowed nonregulated costs to be treated as incidental and considered regulated so long as the incidental activity is clearly identified in the cost manual, the activity is not a separate line of business, and the activity was traditionally treated as incidental for regulated accounting purposes. Finally, we found that the total of a carrier's incidental activities could not exceed one percent of its total revenues.[256]

2. **Positions of the parties**

166. *Treatment of specific services as regulated*. Telocator-Paging argues that paging and conventional twoway mobile services ought to be treated as nonregulated services under the cost allocation rules. Telocator-Paging provides three reasons for its proposal to treat paging and conventional mobile as nonregulated: (1) some states have deregulated these services; (2) the USOA requires only Tier 1 carriers to account separately for these services, leading to greater opportunities for cross subsidization among non-Tier I carriers; and (3) some BOCs have integrated their paging and cellular operations under a single subsidiary.[257] Telocator-Cellular similarly argues that the provision of cellular by independent telephone companies should also be treated as a nonregulated activity.[258] The proposals of Telocator-Paging and Telocator Cellular are opposed by NYNEX and Southwestern. Both parties argue that the instant docket is not the proper forum for deciding the regulatory status of mobile services and that the *Order* presently provides for the cost of these services to be treated as regulated.[259]

167. GTE objects to our decision to treat detariffed billing and collection costs as regulated and to affirm thereby the use of the jurisdictional separations and access charge systems to identify interstate billing and collection costs. GTE argues that billing and collection costs are not adequately identified by jurisdictional separations or access charges, and that all services deregulated in the interstate arena should be treated as nonregulated. According to GTE, use of the cost allocation system to define nonregulated billing and collection costs, instead of jurisdictional separations and access charges, would produce a more accurate result

[256]*Id.* at 1308.

[257]Telocator-Paging Petition at 2-4.

[258]Telocator-Cellular Petition at 4.

[259]NYNEX Opposition at 7-8 and Southwestern Opposition at 17- 18.

due to the more extensive auditing controls established as part of the cost allocation process. GTE also argues that its proposal would not distort jurisdictional separations if billing and collection costs were identified prior to jurisdictional separations, but left in the accounts for the purpose *of* calculating an interstate revenue requirement, and the access charge rules were modified so that billing and collection costs for access charge purposes is the same as that for cost allocation purposes.[260] The Pacific Companies argue that GTE's proposal should not be adopted because GTE has failed to provide evidence that billing and collection costs are identified more accurately through the cost allocation process than through Part 69.[261]

168. IDCMA objects to our one percent revenue cap on incidental activities. IDCMA argues that the limit ought to be one-tenth of a percent.[262] IDCMA's proposal is opposed by several carriers, on the grounds that this Commission has established both quantitative and qualitative guidelines which will operate in tandem to ensure that nonregulated activities are not incorrectly treated as incidental.[263]

169. Effects on jurisdictional separations. NARUC argues that for services deregulated in the interstate jurisdiction only, the cost allocation process established in the *Order* should be conducted after a carrier performs jurisdictional separations. NARUC advocates that this approach will minimize any shifts in jurisdictional revenue requirements. NARUC argues that by removing some of the costs of assets from regulated operations, the cost allocation process necessarily eliminates some usage, which affects jurisdictional separations. Alternatively, NARUC recommends that the cost allocation rules be referred to a joint board.[264]

170. A number of parties oppose NARUC's suggestion. Bell Atlantic and NYNEX argue that NARUC's request is unnecessary because the only service deregulated at the federal level and not at the state level is billing and collection. So long as billing and collection costs are treated as regulated costs and are subject to jurisdictional separations, Bell Atlantic argues that NARUC's concerns are satisfied.[265] The Pacific Companies and MCI argue that NARUC's proposal is unworkable because the cost allocation rules are not designed to operate with separations type procedures, and would not permit adequate identification of interstate nonregulated costs. The Pacific Companies also argue that since this Commission has not

[260]GTE Petition at 21-25.

[261]Pacific Companies Opposition at 10.

[262]IDCMA Petition ar 14-16.

[263]Ameritech Opposition at 14-15; BellSouth Opposition at 13-14; Pacific Companies Opposition at 6-7; Southwestern Opposition at 13-14; and USTA Opposition at 12. *See also* Bell Atlantic Opposition at 6-7; and NYNEX Opposition at 7.

[264]NARUC Petition at 1-6 and Reply at 4.

[265]Bell Atlantic Opposition at 12- 13 and NYNEX Opposition at *5. See* also USTA Opposition at 13-14 and BellSouth Opposition at 16-17.

mandated the use of its cost allocation system by the states. there is no need to convene a joint board.[266]

171. In response, NARUC disagrees that its request is unnecessary. NARUC states that although the accounting procedure for billing and collection has been resolved, the procedure for other services that could be deregulated on the interstate level has not been resolved. Furthermore, NARUC argues that the cost allocation rules were not necessarily intended to precede jurisdictional separations, since this Commission has indicated it would resolve these questions on a case-by-case basis.

3. **Discussion**

a. **Treatment of specific services as regulated.**

172. *Mobile services.* We reject Telocator-Paging's and Telocator's-Cellular's proposals to treat common carrier mobile services as nonregulated activities in applying the cost allocation standards. Our intent in adopting procedures to handle activities given disparate regulatory treatment was to preserve existing relationships to the separations and access rules. By considering the costs of mobile services to be regulated costs, those relationships remain intact. While there may exist reasons to alter the treatment of mobile services under our cost allocation plan, we find the record in this proceeding wholly inadequate to support such a modification. The petitions of the parties will therefore be denied.

173. *Billing and Collection.* We also reject GTE's proposed treatment of billing and collection for similar reasons. Removal of billing and collection costs prior to separations would no doubt change the outcome of jurisdictional separations. Moreover, it appears that the crux of GTE's objection lies with the scope of billing and collection under Part 69. Those objections should be raised in a different proceeding.

174. *Incidental Activities.* IDCMA's proposals to place additional limits on the amount of incidental revenues is also unwarranted. The various qualitative and quantitative tests we have established in order for a nonregulated service to qualify for incidental regulated treatment will sharply curtail the classification of services as incidental ln addition, there is evidence that a one-tenth of one percent limit would, for some companies, preclude incidental treatment of traditionally incidental activities such as pole attachment and conduit space rental, which contribute to the reduction of regulated revenue requirement yet pose little or no threat of cross-subsidization. We agree, therefore, with those who argue that no additional limitations on incidental services are necessary.

175. *Effects on jurisdictional separations*. We also reject NARUC's proposal to treat all services deregulated at the interstate level, but not deregulated at the state level, as regulated for cost allocation purposes. Although we reject NARUC's proposal, we are sensitive to the problems that might arise in the future if services are deregulated that contribute a significant amount of usage to the network. At present, however, we do not have plans to deregulate

[266]Pacific Companies Opposition at 4-6 and MC Opposition at 2-4.

additional services, and we therefore decline to create a categorical rule to address what is currently a hypothetical problem. For the future, we continue to believe the best course is to resolve these issues on a case-by-case basis, as we recited in the *Order*. We therefore also deny NARUC's alternate request to refer the cost allocation rules to a joint board.

Vl. IMPLEMENTATION AND ENFORCEMENT

A. Auditing

1. Background

176. In the *Order*, we concluded that an independent audit would be an important aid to this Commission in implementing our commitment to monitor compliance with our cost allocation requirements. We required all carriers subject to cost allocation manual filing requirements to commission an independent audit attesting that the cost allocation system in place properly implements the approved manual, and that the cost allocations performed in accordance with the manual are the product of accurate methods. The audit, along with the auditors' workpapers, was to be made available to Commission staff. In addition, we decided that the appropriate level of assurance is an examination leading to a positive opinion.[267] We also decided not to require an audit prior to implementation. We found that the value of an attestation concerning manual compliance would not justify the cost involved, since this Commission must reach a similar decision in approving the manuals prior to their implementation.

2. **Positions of the parties**

177. " Positive Opinion " Audits. The majority of parties who submitted comments during the reconsideration pleading cycle favor modification of the *Order*, arguing that they will experience significant cost savings in using "negative assurance" as opposed to a "positive opinion attestation. According to the parties, a positive opinion "examination" audit would require the auditor to state whether, in his or her opinion, the presentation of assertions is presented in conformity with established criteria, while a negative assurance or "review-type" audit would require the auditor to state whether any information came to his or her attention during the audit indicating that the assertions were not in conformity with the establish criteria. Bell Atlantic argues that while a "positive opinion" audit may cost it as much as $1 million, "negative assurance" audit would reduce its auditing costs by as much as 75 percent, and would sufficiently satisfy the Commission of its compliance with the cost manual.[268]

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[267] *Joint Cost Order*, FCC Rcd at 1330-31.

[268] Bell Atlantic Petition at 12-15. Bell Atlantic suggests that the audit should be limited to 1) a general review of internal policy, and procedures for cost manual implementation; 2) selected reviews of cost pool allocations, as implemented; 3) selected verification of the numerical accuracy of the allocation result presented to this Commission; 4) identification of underlying data sources used in cost manual implementation; and 5) a general review of selected underlying data sources and special studies that have a significant material impact on allocation results.

Similarly, U S West states that a "negative assurance audit could reduce auditing costs by as much as 50 percent.[269] Rochester and Southwestern agree with Bell Atlantic, stating that the "negative assurance" audit could substantially reduce auditing costs.[270] In addition, Southwestern argues that its financial operations are already subject to an annual examination type audit by an outside accounting firm. USTA believes that a "negative assurance" audit would adequately assure carrier compliance while reducing auditing costs to a point where there would be a net benefit to the ratepayer.[271]

178. Those opposing the proposed modification express limited disapproval of Bell Atlantic's suggestion. All of the opposing parties contend that a "positive opinion" audit necessary, at least initially, to assure compliance with the Commission's cost allocation requirements. Nevertheless, the Pennsylvania Consumer Advocate and the D.C. Commission concede that "negative assurance" audits may be permissible after several "positive opinion" audits has been satisfactorily conducted.[272] The Pennsylvania Consumer Advocate conditions the modification on the continued use of "positive opinion" audits on a "rotation basis".[273] The D.C. Commission states that a "positive opinion" audit may be available at a lower rate than that quoted to Bell Atlantic, and opposes Bell Atlantic's suggestions to limit "negative assurance" audits to five areas. The D.C. Commission states that the audit should include review of data and special studies which may have impact on allocation results.[274]

179. IDCMA views the use of an independent audit "indispensable" to this Commission's compliance program and argues that a "positive opinion" is the only way to assure the adequacy of the auditors' procedures. Moreover, IDCMA states that the cost of the examination audit is small in comparison to the amount of revenues generated by the carriers and is justifiable in light of the significant impact on ratepayers from cost misallocations.[275]

180. In response, Bell Atlantic argues that opponents of the "negative assurance" audit have not stated what benefits the "positive opinion" audit provides which justify the additional cost.[276]

181. *Additional types of Audits*. Two parties advocate additional auditing requirements. In

[269]U S West Opposition at 2-3.

[270]Rochester Reply at 4-5 and Southwestern Opposition 14- 15

[271] USTA Reply at 8.

[272]Pennsylvania Consumer Advocate Opposition at 4-6 and D.C. Commission Opposition at 6-7.

[273]Pennsylvania Consumer Advocate Opposition at 4-6.

[274]D.C. Commission Opposition at 6-7.

[275]IDCMA Opposition at 20-22.

[276]Bell Atlantic Reply at 10-11.

its petition, IDCMA states that this Commission has a "statutory mandate" to ensure that the carriers' accounting systems are effectively designed and implemented.[277] To fulfill that mandate, IDCMA suggests: 1) that this Commission require the independent auditors to obtain and submit "baseline" information on the cost of regulated activities, prior to the implementation of cost allocation manuals; 2) that this Commission conduct one annual "bellwether" audit of a regional BOC, and 3) that independent auditors report to this Commission on areas within carrier's manual that require changes.[278] Similarly, Ad Hoc proposes that this Commission reserve the right to require a "full compliance" audit prior to the implementation of the carrier's cost allocation manual. Ad Hoc expresses concern that the current auditing requirements may be insufficient in disclosing improper or erroneous allocations made at the time of implementation, which could have a permanent effect on cost allocations. Ad Hoc argues that an "initial compliance" audit conducted after the 30-day manual review period would aid in avoiding initial allocation errors. At the least, according to Ad Hoc, this Commission should reserve the right to conduct such an audit.[279]

182. Parties responding to IDCMA and Ad Hoc's proposals generally disfavor the idea of additional auditing requirements. BellSouth states than any supplemental audits would be costly to conduct and not essential to this Commission's review. Moreover, BellSouth contends that any "bellwether" audits conducted by this Commission would be unnecessary in light of the existing auditing requirements.[280] SNET contends that additional requirements would burden this Commission as well as the carriers.[281] The Pacific Companies and USTA argue that additional audits are unnecessary and duplicative of the manual review process. According to the Pacific Companies, the value of such an audit would be limited because no implementation results would be available. Additionally, USTA and Bell Atlantic argue that any further auditing requirements will hamper the carriers' ability to implement their cost allocation manuals in a timely fashion.[282]

3. Discussion

183. "Positive Opinion" Audits. As part of its "Statement on Standards for Attestation Engagements," the American Institute of Certified Public Accountants (AICPA) states that attest reports should be limited to one of two standards of assurance--an examination leading to "positive opinion" or a review leading to an expression of "negative assurance "

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[277]IDCMA Petition at 20.

[278]*Id.* at 21.

[279]Ad Hoc Petition at 16-18.

[280]BellSouth Opposition at 11-12.

[281]SNET Reply at 1-3.

[282]The Pacific Companies Opposition at 11-12; USTA Opposition at 6-7; and Bell Atlantic Opposition at 10-12.

When expressing a positive opinion, the practitioner should clearly state whether, in his or her opinion, the presentation of assertions is presented in conformity with established or stated criteria.[283]

The AICPA describes a negative assurance review differently. In providing a negative assurance, the petitioner's conclusion should state whether any information came to the practitioner's attention on the basis of the work performed that indicates that the assertions are not presented in all material respects in conformity with established or stated criteria.

Moreover, the AICPA standards specify that the negative assurance review should indicate the work performed was less in scope than an examination leading to a positive opinion and should expressly disclaim a positive opinion on the assertions.[284] The two types of attestation audits are therefore quite different.

184. In determining whether a carrier's cost allocation practices are in conformity with its manual, independent auditors are currently required to provide us with a positive opinion that the manual is being followed, that the cost allocations performed are correct,and that the cost allocations are the product of accurate methods. We required a positive opinion on these subjects because we felt that, as a tool for our monitoring of cost allocations, the independent audit was an indispensable factor in our ability to enforce the rules we established.[285] A negative assurance review would, by contrast, not provide the level of assurance we require in order to ensure that our requirements are being met. We perceive no reason to change our views.

185. We recognize that the cost of an examination-type audit may be large in comparison to the nonregulated revenues earned by the carriers, at least initially. However, the purpose of the independent audit is to assist us in determining if our rules, which are designed to protect ratepayers, are being followed. We believe that it is important to ensure that costs are being allocated pursuant to our rules right from the start, when nonregulated costs and revenues are still relatively small. Furthermore, the anticipated cost of the audits, when viewed in the context of total carrier revenues, is quite small. We therefore affirm our view that a positive opinion audit should be required.[286]

186. *Additional Types of Audits*. We deny requests to impose additional audit requirements on the carriers. Ad Hoc's suggestion for an "initial compliance" audit prior to manual

[283]American Institute of Certified Public Accountant "Statement on Standards for Attestation Engagements," March 1986 at 17.

[284]*Id.* at 18-19.

[285]*Joint Cost Order*, FCC Rcd at 1330.

[286]We will not at this time adopt suggestions that negative assurance audits be required after several years of positive opinion audits. We believe this issue should be resolved after we have had some experience with the positive opinion audits and carrier compliance with our rules.

implementation duplicates the manual review process we will undertake. IDCMA s proposal for one Commission audit per year of a regional BOC is also unnecessary in view of our independent audit requirement Commission resources are better spent on an in depth review of the independent audit results and with auditing of affiliate transactions for compliance with our rules. We also reject as unnecessary IDCMA's proposal to obtain pre-implementation "baseline" information on regulated activities. We do not believe that such information will contribute to our monitoring efforts. Also, we reject IDCMA s proposal to require auditors to suggest changes in the manual. The proposal will only add to the auditing expense and can be accomplished through our oversight and review of manual implementation.

B. Cost Allocation Manuals

1. Background

187. *The Joint Cost Order* set forth a description of the content required in each cost manual.[287] While we mandated the inclusion of certain information, such as allocation mechanisms by account or subaccount, we did not require that manuals be completely uniform.

2. Positions of the parties

188. *Use of function codes*. Ad Hoc argues that the cost allocation process should include allocations based on "function codes,"[288] in addition to allocations for USOA accounts and subaccounts. Ad Hoc asserts that if more than 10 percent of the nonregulated cost allocation for a specific account resides in a given function code, the manual ought to list the function code separately from the account.[289] Ad Hoc's proposal is opposed by numerous carriers, who argue that function codes vary by carrier, and that the addition of function codes to the manual will impose additional burdens on carriers, while not contributing toward auditability of carrier performance.[290] In response, Ad Hoc argues that because all carriers use function

[287]The five parts of the manual are: (A) description of each of the company's nonregulated activities; (B) list of all the activities to which the company now accords incidental accounting treatment, and the justification for treating each as incidental; (C) chart showing all of its corporate affiliates; (D) statement itemizing affiliates that engage in or will engage in transactions with carrier entity and describing the nature, terms, and frequency of such transactions; (E) for each USOA account and subaccount detailed specifications of the cost categories to which amount the account or subaccount will be assigned and of the basis which each cost category will be apportioned. *Joint Cost Order,* 2 FCC Rcd at 1328.

[288]Function codes are used to isolate specific activity function within an account or subaccount and may be created or dissolved from time to time as activities are completed.

[289]Ad Hoc Petition at 12-14.

[290]Bell Atlantic Opposition at 9-10; BellSouth Opposition at 11; NYNEX Opposition at 2-3; Pacific Companies Opposition at 8-10; and USTA Opposition at 4-5.

codes, their inclusion in the manuals would not be burdensome.[291]

189. *Uniformity*. Ad Hoc and IDCMA advocate increased uniformity in the cost manuals. Ad Hoc and IDCMA argue that some degree of uniformity is essential if this Commission is to pursue its "benchmark" regulation of the BOCs. According to Ad Hoc, the BOCs' nonregulated activities are not likely to differ substantially, and aggregate comparisons can and should be made. The development of similar cost allocation systems is necessary so that the results can be compared.[292] The carriers oppose uniformity, arguing that each carrier exhibits unique characteristics in terms of its organization, accounting practices and nonregulated activities. The carriers also state that the requirements set forth by this Commission will contribute toward a degree of similarity in the manuals and that additional uniformity is unnecessary.[293] In reply, Ad Hoc says that it is not advocating strict uniformity, although it does advocate manuals that are conceptually consistent. IDCMA argues that there will necessarily be some similarity in the manuals, and this Commission should apply the "best ideas" gleaned from them to all manuals.[294]

190. *Capital appropriations information*. IBM argues that manuals should include procedures for documenting the authorization of and the aggregation of assets and the offsetting sources of funds (debt or equity).[295] According to IBM, this information is important because it is through the capital appropriations process that companies reflect their anticipated needs.

3. Discussion

191. *Use of function codes*. We have decided not to mandate the inclusion of function codes in the cost manuals. We believe the requirement that the manuals set forth detailed specifications of cost categories to which accounts in each USOA account and subaccount will be assigned and the basis on which each cost category will be apportioned will provide sufficient detail without the mandatory inclusion of function codes. Function codes vary from carrier to carrier and to some extent from period to period. Although carriers should use function codes to maximize their attribution of costs, the mandatory inclusion of these codes in the manual would not make them more auditable, would not improve uniformity among carriers, and could make the manuals subject to more frequent revision, which increases burdens on the carriers and this Commission.

[291] Ad Hoc Reply at 4-6.

[292] Ad Hoc Petition at 7-12 and IDCMA Petition at 5-7.

[293] Ameritech Opposition at 3-5; BellSouth Opposition at 10; NYNEX Opposition at 2; Pacific Companies Opposition at 8-10; and USTA Opposition at 3-4.

[294] Ad Hoc Reply at 2-4 and IDCMA Reply at 2-4.

[295] IBM Opposition at 4, n.7.

192. *Uniformity*. We also will not adopt the suggestions of Ad Hoc or IDCMA to require greater uniformity in the cost allocation manuals. We believe that the manual requirements presently mandate sufficient uniformity to enable comparisons between carriers to be made. Furthermore, we anticipate that over time, carriers will adopt procedures from each others' manuals that will render the manuals much more alike. We believe that presently, at the initiation of the cost allocation regime, it is important to give carriers an opportunity to develop divergent solutions to cost allocation problems so that we and they, can evaluate which solutions work best. To mandate increased uniformity now may well hinder the development of the "best ideas" these parties seek.

193. *Capital appropriations information*. We are not persuaded by IBM's arguments that the manuals should include procedures for documenting the authorization of and the aggregation of assets and the offsetting sources of funds. It is not readily apparent to us how this information would assist us in evaluating the carriers' allocation procedures, and we are disinclined to add to an already substantial filing requirement the inclusion of information of questionable value.

C. Reporting and Recordkeeping

1. Background

194. The *Joint Cost Order* stated that monitoring of the cost allocation process and its results would be an important component of this Commission's enforcement efforts. The specifics concerning which financial and operating data should be submitted were deferred to our *Automated Reporting Requirements* proceeding.[296] We stated that monitoring would begin as soon as manuals are approved. We also stated that carriers should retain a complete audit trail of all cost allocations and affiliate transactions.[297]

2. Positions of the parties

195. Only one party requested modifications to this aspect of our decision. IBM argues that we should require carriers to keep complete subsidiary records to support cost allocations. and that this requirement should similarly be reflected in the *Automated Reporting Requirements* proceeding.[298]

3. Discussion

196. We believe that the recordkeeping requirement established in Section 32.23 of the Commission's Rules, "Nonregulated activities," are adequate. Essentially, carriers are

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[296] Automated Reporting Requirements for Certain Class A and Tier I Telephone Companies, CC Docket No. 86-182, FCC 87-242, released September 17, 1987.

[297] *Joint Cost Order*, FCC Rcd at 1328-29.

[298] IBM Opposition at 10, n. 20.

required to account for a nonregulated activity in a separate set of books when the activity does not involve the common or joint use of assets in the provision of both regulated and nonregulated products and services. When nonregulated activity does involve the common or joint use of assets and resources, carriers are required to account for the activity in accounts prescribed for telephone company operations and are required to subdivide assets and expenses in subsidiary records. The subsidiary record should identify amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities and amounts related to assets and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. This section also provides that carriers shall submit reports identifying regulated and nonregulated amounts. We see no need for additional requirements, and therefore, we are not adopting IBM's suggestion that we impose additional record keeping requirements.

D. Proprietary Information Issues

1. Background

197. The *Joint Cost Order* deferred to the Automated Reporting Requirements proceeding questions concerning the proprietary nature of the information to be collected. We required, however, that both the independent audit and the auditor's workpapers be available to Commission staff, and we mandated that all contracts for independent audits include a provision recognizing Commission access to auditor workpapers.[299]

2. Positions of the parties

198. Ad Hoc raises two issues regarding our decision. First, Ad Hoc disagrees with our decision to defer proprietary information issues to the Automated Reporting Requirements docket. Ad Hoc states that at a minimum, a new round of comments needs to be solicited in that docket before the issues can be satisfactorily resolved. Ad Hoc also argues that all carrier- and auditor-filed data ought to be made public unless this Commission determines confidential treatment is warranted, with carriers bearing the burden of justifying confidential treatment.[300]

199. Ad Hoc's arguments are opposed by the carriers. They argue that Ad Hoc is simply attempting to gain access to competitively sensitive information, and that the issues should properly be resolved in the Automated Reporting Requirements docket.[301]

200. In addition to Ad Hoc's argument, U S West alleges that this Commission ought not to require disclosure of auditor workpapers because legislatures in 17 states prohibit

[299] *Joint Cost Order,* FCC Rcd at 1334.

[300] Ad Hoc Petition at 14-16.

[301] Ameritech Opposition at 5-8; BellSouth Opposition at 13; NYNEX Opposition at 4, n.7; Pacific Companies Opposition at 11; Southwestern Opposition at 15-16; and USTA Opposition at 5-6.

disclosure of workpapers.[302]

3. Discussion

201. We reject both of Ad Hoc's arguments. The Automated Reporting Requirements Order sets forth the procedures we will follow in handling information which is alleged to be proprietary. Our decision in that proceeding was made based on a review of the comments leading to the Joint Cost Order,[303] as well as the comments in the Automated Reporting Requirements proceeding itself. Based on our review of the complete record, we decided to fashion a reporting mechanism that was consistent with our existing Freedom of Information Act rules.[304] Carriers seeking confidential treatment of data were required to submit two copies of both the paper and computer media report. One copy must contain all the required information, while the second should contain only that information which the carrier is willing to have publicly available.[305] Information submitted under a claim of confidentiality will not be released until a party requests its release pursuant to Section 0.461, this Commission has granted the request, and the relevant period for filing an application for review or judicial stay has expired. We find no merit in Ad Hoc's suggestion to establish a different procedure whereby all records are considered public unless the party submitting the information proves otherwise. Our experience with our existing rules leads us to conclude that they afford full and fair procedural protections for all parties concerned, and assure prompt resolution to disputes over the confidentiality of information.

202. We also reject U S West's argument that state laws preclude our staff from accessing auditor workpapers. U S West presents no new facts or arguments that warrant reconsideration. While we recognized that state laws concerning disclosure of auditor's workpapers did exist, we found that the purpose of those laws was wholly unrelated to the exercise of our responsibilities under the Communications Act to access workpapers from an audit which we mandated and which we have found to be in the public interest. We continue to believe our decision is correct.

VII. CLARIFICATION OF ACCOUNTING PROCEDURES

203. Since the release of the *Joint Cost Order*, we have discovered several minor problems that result from the interaction of our revised USOA with the accounting provisions of the Order. No party filed for reconsideration on these issues. On our own motion, we are

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[302] U S West Opposition at 3-4.

[303] As part of the *Joint Cost Order*, we decided to incorporate the comments concerning proprietary information issues into the record for the *Automated Reporting Requirements* decision. *Joint Cost Order*, 2 FCC Rcd at 1328.

[304] See 47 C.F.R. § 0.461.

[305] *Automated Reporting Requirements, supra* n. 295 at para. 50.

making minor adjustments to several Part 32 rules to ensure that nonregulated activities receive proper accounting treatment. We find that good cause exists to enact the following amendments to our rules without notice and comment Rule Making. Each of the changes is minor in nature and corrects technical problems with the USOA that were undetected when we initially adopted the Joint Cost Order. If these minor amendments were not made, additional accounts would have to be created to reflect an accurate presentation of assets and carrier costs, or other procedures would have to be adopted to ensure that a correct statement of revenues and expenses is available. Furthermore, the changes which we make affect only a few accounts and must be adopted sufficiently in advance of the January 1, 1988 implementation date for the revised USOA to enable carriers to adjust their accounting systems. A notice and comment Rule Making is therefore impracticable, unnecessary, and contrary to the public interest.[306]

A. Part 32 Amendments

204. *Account 1220*. The *Joint Cost Order* provided that if a nonregulated activity involves joint or common use of assets and resources with regulated activities, the material and supplies which are related to the nonregulated activity should be included in account 1220, "Material and Supplies."[307] Because such nonregulated activities may involve inventories of property held for sale or lease, this account may include more than just the material and supplies held by a company for use in its operations. Considering the distinction between inventories of material and supplies held for use in operations and inventories of property acquired for sale or lease, we find the account title and text should be amended to better reflect what is includible in this account.

205. We have decided that the account title "Inventories" would be more descriptive since account 1220 may include more than just the material and supplies held by a company for use in its operations. Further, the account should be maintained in subaccounts that reflect the distinction between inventories of material and supplies and inventories of property acquired for sale or lease to others.[308]

206. *Accounts 2311 and 2341*. When items are leased to others under operating leases, it is not suitable to leave such items recorded in the inventory account. Items rented to others under operating lease[309] agreements should be reclassified from inventory accounts to plant or equipment accounts as determined by the nature of the property leased. In view of this, we

[306]5 U.S.C. § 553(b). The changes to the Part 32 rules are effective 6 months from date of publication in the Federal Register. *See* 47 U.S.C. § 220(g). In the interim, carriers should refer to Responsible Accounting Officers Letter 9, dated September 1. 1987.

[307]*Joint Cost Order,* FCC Rcd at 1345.

[308]The amendments to Section 32.1220 appear in Appendix C.

[309]The existence of an operating lease should be determined by reference to criteria for classifying leases as prescribed by the Financial Accounting Standards Board (FASB) in FASB Statement No. 13, as amended and interpreted.

have decided to amend Account 2311, "Station apparatus," and Account 2341, "Large private branch exchanges." Use of these accounts was restricted to carriers having authority to offer tariffed CPE after December 31, 1987. Since the provisions of the Order require distinctions between regulated and nonregulated costs in plant accounts, there is no reason why these accounts could not be used for property under operating leases to others. We will therefore amend Sections 32.2311 and 32.2341 to eliminate the restrictions established for these accounts as a result of CPE detariffing when the new Part 32 was adopted.[310] Under the amendments adopted here, use of these accounts by all carriers will provide a mechanism for recording CPE when it is rented to customers under operating leases.[311]

207. *Accounting for services obtained under tariff.* The *Joint Cost Order* provided that "tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service."[312] This procedure may overstate revenues and, depending upon the related debits, may overstate expenses. We believe,therefore, that a clarification of this requirement is necessary.

208. As stated in the Order, the full tariffed rates will be credited to the regulated revenue accounts. The corresponding debit entry shall be made to account 7991, "Other nonregulated revenues." Customer billings for enhanced services which include or utilize basic services charged to the nonregulated activity in the manner required herein will be recorded in full in account 7991. This will continue to assure that the regulated ratepayer does not subsidize the nonregulated activities through the provision of basic services at less than tariffed rates, and, at the same time, it will maintain the correct statement of revenues and expenses on a company-wide basis. Further, on a service-by-service basis, recorded revenues will correctly reflect services rendered, since the procedure required herein will effectively divide the revenues between basic and enhanced services.[313]

VIII. ORDERING CLAUSES

209. We certify that the Regulatory Flexibility Act[314] is not applicable to the changes we are proposing in this proceeding. In accordance with the provisions of Section 605 of that Act, a copy of this certification will be sent to the Chief Counsel for Advocacy of the Small Business Administration at the time of publication of this Reconsideration in the Federal Register. As part of our analysis of the proposal described in this Order, however, this

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[310] Of course, carriers are free to use separate books of account if they retain their CPE activities in a separate subsidiary. *See* Section 32.23 of the Commission's Rules, *printed in* 2 FCC Rcd at 1344-45.

[311] The amendments to these sections appear in Appendix C.

[312] 2 FCC Rcd at 1318.

[313] An amendment to our Part 32 rules codifying this procedure is included in Appendix C. As part of this Order, we are also correcting a typographical error in Section 32.1406, which should have contained a cross reference to Section 32.23(b).

[314] 5 U S.C. § 601, *et seq.*

Commission has considered the impact of the proposal on small telephone companies, i.e., those serving 50,000 or fewer access lines.[315] Our modifications to the requirements of the Joint Cost Order substantially lessen the regulatory requirements on small carriers because we have exempted average schedule companies from the requirements contained in the Joint Cost Order. Our amendments to Part 32 proposed herein would have a beneficial economic impact on 29 fully subject small telephone companies serving 50.000 or fewer access lines since the amendments clear up technical problems that have been uncovered since the adoption of the Order.

210. IT IS HEREBY ORDERED, that the Motions for Acceptance of Late-Filed Pleadings submitted by Compuserve Incorporated and Capital Cities/ABC, Inc., CBS Inc., and National Broadcasting Company ARE GRANTED.

211. IT IS FURTHER ORDERED, that pursuant to Sections 4(i), 4(j), 201-205, 215, 218, 219, and 220 of the Communications Act of 1934, 47 U.S.C. 154(i), 154(j), 201-205, 215, 218, 219 and 220, that the modifications to the Part 64 rules set forth herein ARE ADOPTED, effective **January 1, 1988.**

212. IT IS FURTHER ORDERED, that pursuant to Sections 4(i), 4(j), 201-205, 215, 218, 219 and 220 of the Communications Act of 1934, 47 U.S.C. 154(i), 154(j), 201-205, 215,218, 219 and 220, that the modifications to the Part 32 rules set forth herein ARE ADOPTED, effective six months after publication in the Federal Register.

213. IT IS FURTHER ORDERED, that pursuant to Sections 4(i), 4(j), 201-205, 215, 218, 219 and 220 of the Communications Act of 1934, 47 U.S.C. 154(i), 154(j), 201-205, 215,218, 219 and 220, that the Petitions for Reconsideration filed in this proceeding ARE DENIED, except as provided herein.

FEDERAL COMMUNICATIONS COMMISSION

William J. Tricarico
Secretary

[315] Because of the nature of local exchange and access service, this Commission concluded that small telephone companies are dominant in their fields of operation and therefore are not small entities as defined by the Regulatory Flexibility Act. *See* MTS and *WATS Market Structure*, 93 FCC 2d 241, 338-39 (1983). Thus, this Commission is not required by the terms of that Act to apply the formal procedures set forth therein. We are nevertheless committed to reducing the regulatory burdens on small telephone companies whenever possible consistent with our other public interest responsibilities. Accordingly, we have chosen to utilize, on an informal basis, appropriate Regulatory Flexibility Act procedures to analyze the effect of proposed regulations on small telephone companies.

APPENDIX A

Petitions for Reconsideration were filed by the following parties:

Ad Hoc Telecommunications Users Committee (Ad Hoc)
American Telephone and Telegraph Company (AT&T)
Ameritech Operating Companies (Ameritech)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation (BellSouth)
Cellular Telecommunications Division of Telocator Network of America (Telocator - Cellular)
Cincinnati Bell Telephone Company (Cincinnati Bell)
Contel Corporation (Contel)
GTE Telephone Companies (GTE)
Independent Data Communications Manufacturers Association,Inc. (IDCMA)
National Association of Regulatory Utility Commissioners (NARUC)
National Telephone Cooperative Association (NTCA)
NYNEX Telephone Companies (NYNEX)
Paging Division of Telocator Network of America (Telocator- Paging)
Public Service Telephone Company (PSTC)
Southwestern Bell Corporation (Southwestern)
The Southern New England Telephone Company (SNET)
United States Telephone Association (USTA)
US Sprint Communications Company (US Sprint)
U S West, Inc. (U S West)
Western Union Telegraph Company (Western Union)

Oppositions were filed by:

Ad Hoc
Ameritech
AT&T
Bell Atlantic
BellSouth
Capital Cities/ABC, Inc., CBS Inc., and National Broadcasting Company, Inc. (The Networks)
CompuServe Incorporated (CompuServe)
IDCMA
International Business Machines Corporation (IBM)
MCI Telecommunications Corporation (MCI)
NYNEX
Office of the Consumer Advocate, Commonwealth of Pennsylvania (Pennsylvania Consumer Advocate)
Office of the Consumers' Counsel. State of Ohio (Ohio Consumers' Counsel)
Organization for the Protection and Advancement of Small Telephone Companies

(OPASTCO)
Pacific Bell and Nevada Bell (Pacific Companies)
Public Service Commission of the District of Columbia (D.C. Commission)
Southwestern
United States Department of Commerce. Assistant Secretary for Communications and Information (Commerce)
USTA
US Sprint
U S West

Replies were filed by:
Ad Hoc
AT&T
Bell Atlantic
BellSouth
Contel
Coopers & Lybrand
D C Commission
GTE
IDCMA
NARUC
NTCA
NYNEX
PSTC
Rochester Telephone Corporation (Rochester)
SNET
Southwestern
USTA
U S West
Western Union

APPENDIX B

Part 64 of Title 47 of the CFR is amended as follows:

1. The authority citation for Part 64 continues to read:

AUTHORITY: Sec. 4, 48 Stat. 1066, as amended; 47 US.C. 154, unless otherwise noted. Interpret or apply secs. 201, 218, 48 Stat. 1070, as amended, 1077; 47 U.S.C. 201, 218, unless otherwise noted.

2. Section 64.901 is amended by revising paragraph (b)(4) to read as follows:

§ 64.901 Allocation of Costs

(a) * * *

(b) * * *

(4) The allocation of central office equipment and outside plant investment costs between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment during the year when nonregulated usage is greatest in comparison to regulated usage during the three consecutive years following the effective date of the current annual access charge filing.

* * * *

3. Section 64.902 is added as follows:

§ 64.902 Transactions With Affiliates

Except for carriers which employ average schedules in lieu of determining their costs, all carriers subject to Section 64.901 are also subject to the provisions of Sections 31.01-11 and 32.27 concerning transactions with affiliates.

APPENDIX C

Part 32 of Title 47 of the CFR is amended as follows:

1. The authority citation for Part 64 continues to read: **AUTHORITY:** 47 U.S.C. 154, 47 U.S.C. 219, 220.

2. Section 32.27 is amended by revising paragraphs (b), (c), and (f) to read as follows:
§ 32.27 Transactions with affiliates.(a)(b) charges for assets purchased by or transferred to the regulated telephone activity of a carrier from affiliates shall be recorded in the operating accounts of the regulated activity at the invoice price if that price is determined by a prevailing price held out to the general public in the normal course of business. If a prevailing price for the assets received by the regulated activity is not available, the charges recorded by the regulated activity for such assets shall be the lower of their cost to the originating activity of the affiliated group less all applicable valuation reserves, or their fair market value.

(c) Assets sold or transferred from the regulated accounts to affiliates shall be recorded as operating revenues, incidental revenues or asset retirements according to the nature of the transaction involved. If such sales are reflected in tariffs on file with a regulatory commission or in a prevailing price held out to the general public, the associated revenues shall be recorded at the prices contained therein in the appropriate revenue accounts. If no tariff or prevailing price is applicable, the proceeds from such sales shall be determined at the higher of cost less all applicable valuation reserves, or estimated fair market value of the asset.

* * * * *

(f) Companies that employ average schedules in lieu of actual costs are exempt from the provisions of this section.

For other organizations, the principles set forth in this section shall apply equally to corporations, proprietorships, partnerships and other forms of business organization.

3. Section 32.1220 is revised to read as follows:

32.1220 Inventories.

(a) This account shall include the cost of materials and supplies held in stock and inventories of goods held for resale or lease. The investment in inventories shall be maintained in the following subaccounts:

1220.1 Material and supplies 1220.2 Property held for sale or lease (b) These subaccounts shall not include items which are related to a nonregulated activity unless that activity involves joint or common use of assets and resources in the provision of regulated and nonregulated products and services.

(d) Transportation charges and sales and use taxes, so far as practicable, shall be included as a part of the cost of the particular material to which they relate. Transportation and sales and use taxes which are not included as part of the cost of particular material shall be equitably apportioned among the detail accounts to which material is charged.

(e) So far as practicable, cash and other discount on material shall be deducted in determining cost of the particular material to which they relate or credited to the account to which the material is charged. When such deduction is not practicable, discounts shall be equitably apportioned among the detail accounts to which material is charged.

(f) Material recovered in connection with construction, maintenance or retirement of property shall be charged this to account as follows:

> (1) Reusable items that, when installed or in service, were retirement units shall be included in this account at the original cost, estimated if not known. (Note also 32.2000(d)(3) of this subpart.)
>
> (2) Reusable minor items that, when installed or in service, were not retirement units shall be included in this account at current prices new.
>
> (3) The cost of repairing reusable material shall be charged to the appropriate account in the Plant Specific Operations Expense accounts.
>
> (4) Scrap and nonuseable material included in this account shall be carried at the estimated amount which will be received therefor. The difference between

the amounts realized for scrap and nonuseable material sold and the amounts at which it is carried in this account, so far as practicable, shall be adjusted in the accounts credited when the material was taken up in this account.

(g) Interest paid on material bills, the payments of which are delayed, shall be charged to Account 7540. Other interest deductions.

(h) Inventories of material and supplies shall be taken during each calendar year and the adjustments to the account shall be charged or credited to Account 6512, Provisioning expense.

(i) 1220.2 Property held for sale or lease. This subaccount shall include the cost of all items purchased for resale or lease. The cost shall include applicable transportation charges, sales and use taxes, and cash and other purchase discounts. Inventory shortage and overages shall be charged and credited, respectively, to Account 7991. Other nonregulated revenues.

4. Section 32 1406 paragraph (a), as released on February 6. 1987, is corrected to read as follows:

32.1406 Nonregulated investments.

(a) This account shall include the carrier's investment in nonregulated activities accounted for in a separate set books as provided in Section 32.23(b).

5. Section 32.2311 paragraphs (g) and (h) are revised to read as follows:

32.2311 Station apparatus.

* * * * *

(g) Items of station apparatus in stock for which no further use in the ordinary conduct of the business is contemplated, but which as a precautionary measure are held for possible future contingencies instead of being discarded shall be excluded from this account and included in Account 1220, Inventories.

(h) Embedded CPE is that equipment or inventory which was tariffed or otherwise subject to the jurisdictional separations process as of January 1, 1983.

6. Section 32.2341 paragraph (g) is revised to read as follows:

§32.2341 Large private branch exchanges.

* * * * *

(g) Embedded CPE is that equipment or inventory which is tariffed or otherwise subject to the jurisdictional separations process as of January 1, 1983. Inventories of Large private branch exchanges equipment are included in Account 1220. Inventories

7. Section 32 7991 is amended by revising paragraphs (b) and (c) to read as follows:

§32.7991 Other nonregulated revenues.

(b) This account shall be debited for amounts recorded in the regulated revenue accounts for charges made to nonregulated activities for tariffed services provided to nonregulated activities accounted for as prescribed in §32 23(c) of this subpart.

(c) Separate subaccounts shall be maintained for each nonregulated revenue item recorded in this account.